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The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates

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THE RISE AND FALL OF CHINESE TAX INCENTIVES AND IMPLICATIONS FOR INTERNATIONAL TAX DEBATES

by

Jinyan Li

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**THE RISE AND FALL OF CHINESE TAX INCENTIVES AND
IMPLICATIONS FOR INTERNATIONAL TAX DEBATES**

by

*Jinyan Li**

I. INTRODUCTION

China had no foreign direct investment (FDI) before 1979. Now, it is one of the world's largest recipients of FDI. China has been generous to a fault in granting tax incentives to foreign investors. As of January 1, 2008, however, these FDI-specific incentives will be abolished or phased out. What explains the rise and fall? Were the tax incentives not effective in attracting FDI and promoting China's economic growth? What are the implications of the Chinese experience for international tax debates? This article examines these questions.

Part II of the Article provides an overview of the Chinese tax incentive regimes for FDI. It briefly discusses the creation, expansion, and termination of tax incentives and the key motivations at each stage. Part III evaluates these incentives in terms of their effectiveness, efficiency and fairness. Effectiveness is examined on the basis of general data about FDI growth in China and empirical research on investors' reactions to Chinese tax incentives. The economic efficiency of tax incentives is assessed by looking at the positive externalities of FDI in China, the un-intended distortions to investment behaviour, and the extent to which the incentives lead to tax discrimination against local business. The equity aspect of tax incentives is assessed in terms of the role of tax policy in achieving redistributive justice in China. Part IV explores the implications of the Chinese experience for the debate on the use of tax policy in attracting FDI, harmful tax competition and international redistribution. Part V concludes the paper.

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II. THE RISE AND FALL OF CHINESE TAX INCENTIVES

A. Chinese Income Tax Law Born With FDI Tax Incentives

The modern income tax system in China came into existence with the promulgation of the Chinese-Foreign Equity Joint Venture Income Tax Law¹ (the "EJV Tax Law") in 1980 and the Foreign Enterprise Income Tax (FEIT) Law in 1981.² The former was applicable to equity joint ventures formed by a foreign investor and a Chinese partner (typically at that time a state-owned enterprise). The latter was applicable to other forms of FDI, including contractual joint ventures, joint explorations, and wholly foreign-owned enterprises. Both laws contained generous tax incentives,³ but those under the EJV Tax Law were more generous because China was not very enthusiastic about foreign companies operating in China without a local equity partner.⁴

The two tax laws were among the first laws⁵ fashioned by China to facilitate economic reforms and foreign investment. Back in the late 1970s, China was well aware of the fact that it was 12 hours ahead of the United States in time, but "decades behind in technology, infrastructure ... and in taking its place in world affairs."⁶ China wanted to catch up with the United States through economic development. FDI was expected to boost economic growth by bringing to China not only capital, but also the badly-needed technology,

1. The Income Tax Law of the People's Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment (the "EJV Tax Law"), passed by the National People's Congress (NPC) on 10 September 1980. The implementing regulations for this law were issued by the Ministry of Finance on 14 December 1980. Individual Income Tax Law of the People's Republic of China was also promulgated by the NPC in 1980.

2. The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises, promulgated by the NPC on December 13, 1981 ("FEIT Law"). Instead of the flat rate of 30% of national tax as under the EJV Tax Law, the FEIT Law imposed tax at progressive rates, ranging from 20% to 40%. A local tax was imposed at 10% of the national tax, resulting in the top rate of 44% (as opposed to 33% for equity joint ventures).

3. These include tax holidays and reinvestment refunds. See *infra* notes 44-47.

4. The incentives under the FEIT were thus less generous. For example, a tax holiday of three years was standard under the EJV Income Tax Law, but was available under the FEIT only if the investment was scheduled to operate for at least ten years in farming, forestry, animal husbandry or other low-profit operations.

5. Others include The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures Using Chinese and Foreign Investment, adopted on July 1, 1979 at the second session of the Fifth National People's Congress, amended on April 4, 1990; Regulations for the Implementation of the Equity Joint Venture Law, promulgated by the State Council on September 20, 1983.

6. Allison E. Wielobob, *China's Choice: Tax Incentives to Fund Economic Development*, 9 Temp. Int'l & Comp. L. J. 413, at 416 (1995).

management skills, and access to international markets.⁷ However, creating a regulatory regime for FDI in general and tax system in particular was a daunting task. China had never had an income tax⁸ or a legal tradition familiar to foreign investors. The over 2000 years of cultural and legal tradition led to the use of formal law as primarily penal law and administrative law – a set of commands instructing bureaucrats on how to govern the country.⁹ Under three decades of Maoist governance, “law became politicized and shrunken symbol of governance, used instrumentally as a mere vessel for changing policies.”¹⁰ The combination of the legal tradition and Maoist regime left behind neither traditions nor institutions that would support a legal system appropriate for a market-driven economy.¹¹

The lack of precedence made it necessary for China to consider international experiences as references. Initially, foreign businessmen advised China to offer tax incentives to FDI.¹² Chinese officials were aware of the tax incentives being offered by Indonesia, South Korea, Malaysia, Thailand,

7. Huang, Yasheng, *The Benefits of FDI in a Transitional Economy: The Case of China*, in *New Horizons for Foreign Direct Investment*. Paris, OECD (2003).

8. When the modern income tax was introduced in the United States (1913) and Canada (1917), China was undergoing civil wars and political turmoil, which ended when the Communist Party declared the establishment of the People's Republic on October 1, 1949. After the 1949, foreign capital left China and domestic private capital was confiscated. Capitalism and market were incompatible with the Communist Party-led socialism. The absence of international investment and business transactions eliminated any need for any international taxation. When foreign investors were allowed back to China in the late 1970s, it was considered appropriate to impose an income tax on them. For an overview of the evolution of the Chinese tax system, see Jinyan Li, *Taxation in the People's Republic of China*. Praeger, New York, 1991); Alec Easson and Jinyan Li, *Taxation of Foreign Investment in the Peoples's Republic of China*. Kluwer, The Netherlands (1989). For an overview of the history of legal reform concerning foreign direct investment, see Jian Zhou, *National Treatment in Foreign Investment Law: A Comparative Study from a Chinese Perspective*, 10 *Touro Int'l L. Rev.* 39, at 50-65 (2000).

9. For more discussion on the Chinese legal traditions, see Randall Peerenboom, *China's Long March Toward Rule of Law*. New York: Cambridge University Press (2002); Stanley B. Lubman, *Bird in a Cage – Legal Reform in China After Mao*. Standord, Calif.: Stanford University Press (1999); Stanley B. Lubman, *Looking for Law in China*, *Columbia J. of Asian Law* 1 (2006); Hsu, C. Stephen, ed., *Understanding China's Legal System: Essays in Honor of Jerome A. Cohen*. New York: New York University Press (2003); Xin Ren, *Tradition of the Law and Law of the Tradition: Law, State, and Social*. New York, Greenwood Press 1997.

10. Lubman (2006), *id.*, at 5.

11. *Id.*

12. See Richard Pomp and Stanley Surrey, *The Tax Structure of the People's Republic of China*, 20 *Va. J. Int'l L.* 1 at 12 (1979).

Singapore and other countries.¹³ Chinese officials were advised that some international experts questioned the efficiency and effectiveness of tax incentives,¹⁴ but they remained concerned that China would be unable to compete for FDI unless it offered tax incentives similar to those provided elsewhere.¹⁵

Granting tax preferences was a key strategy from a political, cultural and economic perspective.¹⁶ Politically, granting tax preferences to FDI sent a clear signal to foreign investors China's desire for their investment. This signalling effect was historically important because China suffered from serious image problems due to its previous hostile policies to foreign investors. The choice of the very word in the Chinese language, "you hui" (preferences) for tax incentives conveyed a positive message. This message was widely disseminated and viewed as a key to the success of efforts to promote foreign investment.¹⁷

Offering generous tax preferences to foreign investors was also consistent with Chinese hospitality and respect for friendship. Tax preferences were presented as gifts or rewards to overseas investors. The Confucian way of dealing with foreigners was to be "generous with gifts without calculating the value of tribute and to grant them honours without making heavy demands."¹⁸ The Chinese believed that by showing generosity and hospitality they could exert moral influence on non-Chinese and lead them to "participate in the benefits of (Chinese) civilization."¹⁹ The grant of tax preferences is associated with the Chinese respect or dependence on relationships (or "guanxi" in Chinese) because exchanges of gifts are an important practice in establishing and retaining relationships. Whether foreign investors actually came to China or even expressed an interest in doing business with the country, the Chinese claimed them as friends. Investors could interpret tax preferences as reciprocation for their friendly acts of investing in China.²⁰ This relationship-building effect of tax preferences may have a special appeal to overseas Chinese investors. Some of them may have been affected by the Communist Party's previous harsh policies and may regard gestures such as granting preferential

13. See Liu, Longheng, *Introduction to Chinese Tax Law*. Beijing University Press (1986), at 240 (in Chinese).

14. Pomp and Surrey, *supra* note 12 at 12.

15. *Id.*

16. This promise was first made in the 1979 Equity Joint Venture Law, which was the first piece of legislation governing FDI since the inception of reforms. Just as punitive rates under the previous system were the legacy of policies that reflected past hostility toward foreign and private capital, in new Equity Joint Venture Law was testament to a favourable policy change.

17. Zhaodong Jiang, *China's Tax Preferences to Foreign Investment: Policy, Culture and Modern Concepts*, 18 *NW. J. Int'l L. & Bus.* 549 at 611 (2000).

18. *Id.*, at 618.

19. *Id.*

20. *Id.*, at 630.

treatment as implied apologies and compensation for past ill-treatment. Some overseas Chinese have a strong attachment to their ancestral land and returned to their native villages and hometowns for sentimental as well as business reasons. They felt welcome when local government presented them with gifts, including tax preferences.²¹

The use of tax preferences was also motivated by pragmatic reasons. China was aware of its economic attractiveness to foreign investors: cheap labour, rich natural resources, and a potentially huge domestic market. It also knew that it had limited resources to develop the necessary infrastructure. As such, funding FDI through tax preferences²² (i.e., foregoing the potential tax revenue should FDI actually come and make profit) seemed a good strategy. In addition to solving the potential cash problem, granting tax preferences was also more expedient and may have compensated for the lack of an ideal investment environment.²³ It would take time for China to develop the necessary institutional environment in terms of property rights protection and government policy creditability.

21. *Id.* This emphasis on building relationships through gift exchanges created some problems. Local officials preferred to broad powers in granting tax preferences and to outperform other local officials in competing for the investment, resulting in regional tax competition and disregard of centrally-made tax policy. The tax preferences presumably played an important role in attracting overseas Chinese investors. Much of the Chinese FDI inflow consists of capital from three ethnically Chinese economies: Hong Kong, Taiwan, and Macao. Hong Kong and Taiwan have been among the top source countries of FDI inflow to China. FDI from these three sources accounted for 59.3% of China's total FDI inflows between 1978 and 1999. Ethnic Chinese capital suppliers in Asia, North America and other parts of the world also contributed to the rapid growth of FDI in China. See Huang (1999), *supra* note 7, at 36.

22. See Wielobob, *supra* note 6.

23. For more discussion on these effects, see Richard E. Caves, *Multinational Enterprise and Economic Analysis*. Cambridge University press, Cambridge (1996); John Dunning, *Investment Incentives throughout Asia*, in *Explaining International Production.*, Unwin Hyman, London (1988); —, *Multinational Enterprises and the Global Economy*. Addison-Wesley, New York (1993); Eckhard Janeba, *Attracting FDI in a Politically Risky World*, 43 (4) *International Economic Rev.* 1127-55 (2002); Thomas Porcano and Charles E. Price, *The Effect of Government Tax and Nontax Incentives on Foreign Direct Investment*, 4 *Multinational Business Rev.* 9-19 (1996); Robert J. Rolfe and Richard A. White, *Investors' Assessment of the Importance of Tax Incentives in Locating Foreign Export-Oriented Investment: An Exploratory Study*, 14 *The J. of the American Taxation Association* 39-57 (1992); Dennis Rondinelli and William J. Brupitt, *Do Government Incentives Attract and Retain International Investment? A Study of Foreign-Owned Firms in North Carolina*, 33 (2) *Policy Sciences* 181-205 (2000); and Louise Single, *Tax Holidays and Firm's Subsidiary Location Desires*, 21 (2) *The J. of the American Taxation Association* 17-34 (1999).

B. The Rise

During the 1980s and 1990s, special preferential tax regimes for FDI experienced a huge boom. A major aspect of the Chinese FDI policy is development region by region. The strategy is to concentrate limited resources for the improvement of infrastructure in small geographic areas. Another aspect of the policy is to encourage export, which could not only earn foreign currency, but also keep FDI separate from the domestic market.

In 1980, China established four “special economic zones” (SEZs) along the south coast (i.e. Shenzhen, Zhuhai and Shantou in Guangdong Province and close to Hong Kong, and Xiamen in Fujian Province (across from Taiwan)²⁴ in order to attract investors in general and investors from Hong Kong, Macau, Taiwan in particular. The Central Government allowed these zones to experiment with reforms in governance and regulations and granted additional tax preferences to FDI in these zones.²⁵ The hope was that foreign capital would turn a small number of sites into an overnight success story. The government could then use the success of the SEZs for a variety of political and economic purposes.²⁶

The immediate success of the SEZs led China to designate 14 coastal cities as: “Coastal Open Cities” in 1984. Certain areas of these cities were designated as “economic and technological development areas” and others as “old urban district.”²⁷ Tax incentives in economic and technological development areas were very close to those in SEZs, but incentives in coastal open cities were less generous.²⁸ A third wave of special areas were designated in 1985 – “coastal economic open regions,” consisting of urban and rural areas

24. For discussions of Chinese SEZs, see Kevin B. Bucknall, *China and the Open Door Policy*. Routledge (Nov. 1990) 143-67; Norman Y.T. Ng, *From Special Economic Zones to the Coastal Open Cities: A Strategy for Modernization of China*, in Joseph Y.S. Cheng, ed. *China: Modernization in the 1980s*. Chinese University Press (1989)

25. See Provisional Regulations of the State Council of the People’s Republic of China Regarding the Reduction of and Exemption from Enterprises Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and the Fourteen Coastal Cities, issued by the State Council on Nov. 15, 1984.

26. See Jiang, *supra* note 17; Ng, *supra* note 24, at 448-49; Bucknall, *supra* note 24 at 144.

27. The fourteen coastal cities were Tianjin, Shanghai, Dalian, Qinhuangdao, Yantai, Qingdao, Lianyungang, Nantong, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai.

28. See Jiang, *supra* note 17. For example, a reduced 15% tax rate was applicable to EJV, CJVs and WFOEs in “old urban districts” that were technology or know-how intensive and had an investment exceeding 30 million U.S. dollars and a long investment recovery period, or the projects related to energy, transport or port construction.

in the Yangtze and Pearl River Deltas, and the South Fujian region.²⁹ These regions were generally better positioned than the rest of the country in attracting FDI as they had geographic advantages, a relatively more developed industrial, technological and infrastructure base than the rest of the country, and were the ancestral home to most Overseas Chinese.³⁰ The tax preferences in the SEZs remained the most generous. To allow exactly the same preferential treatment in non-SEZ areas was thought to lead to unhealthy competition and divert attention from SEZs.³¹

In addition to special regions, special FDI projects or activities received preferential tax treatment. The two most well-known types of projects were export-oriented³² and technologically-advanced.³³ Reinvestment in either type of enterprise was eligible for a full refund of the tax paid on the reinvested profit. Other preferred investments include infrastructure projects,³⁴ “productive” activities, agriculture and animal husbandry. Services and passive investment were not encouraged.

The formal tax discrimination between EJV's and other forms of FDI seemed to make little sense by the end of the 1980s. By then, the majority of FDI was either located in special areas or involving preferred investment projects, receiving similar tax preferences, irrespective of the form of the investment. In 1991, the EJV Income Tax and the FEIT were consolidated into the “Foreign Investment Enterprise and Foreign Enterprise Income Tax” (or FIE

29. Jiang, *supra* note 17. The list of coastal economic open regions was later expanded to cover over 150 cities and counties in 8 provinces. See Notice of the State Council Concerning the Enlargement of the Scope of Coastal Economic Open Regions], 1988 Fagui Huibian 446. As a result, they reach the East Liaoning and East Shangdong Peninsulas.

30. These regions had been the main bases of China's traditional export industries like textiles, handicrafts, light industry and native products.

31. Jiang, *supra* note 17, at 575.

32. “Export-oriented enterprises” were defined as enterprises that produce goods mainly (over 70%) for export and maintain a net positive foreign exchange balance at the end of the year.

33. “Technologically-advanced enterprises” were enterprises which, with advanced technology provided by foreign investors, are able to develop new products, or upgrade existing products, and therefore earn foreign exchange through exports or import substitution.

34. Irrespective of the location of the investment, the tax rate was reduced to 15% for equity joint ventures in port and berth construction projects. New projects scheduled to operate for 15-years or more were eligible for a 10-year tax holiday (a 5-year exemption followed by a 5-year 50% reduction in tax). The tax holiday might be extended upon approval by the Ministry of Finance. Withholding tax on distributions of profits was waived, as was the local income tax. See Jiang, *supra* note 17.

Tax).³⁵ Existing tax incentives granted by way of administrative decrees were incorporated into the new law.

After 1991, new tax incentives continued to be granted. The Pudong New District was created in the City of Shanghai³⁶ in order to develop Shanghai into a world-class financial centre. Other “special” regions included western regions, North-East regions, border cities, bonded zones, tourist and resort areas, and “High and New Technology Industrial Development Areas.”³⁷ The rise of special areas away from the coastal regions effectively made the special tax regimes in the coastal region less special. As a result, the coastal regions created new types of special zones to remain competitive, including bonded zones, free trade zones, high and new industrial development zones, Taiwan investment zones, Singapore-Suzhou industrial park, tourist and resort zones.³⁸ By the end of the 1990s, there were over 100 special areas. As a result of these tax incentives, the effective tax rate for FIEs was about 10 percentage points lower than that for domestic enterprises.

C. The Fall

So long as the FDI did not compete with Chinese firms, the most effective way of using the tax system to attract FDI was to give it only to foreign investors.³⁹ By the turn of the century, especially after China’s accession to the WTO in 2001, however, the FDI tax policy was under close scrutiny and heatedly debated. The negative impact of such policy became more serious, while the positive signalling, compensation and hospitality effects wore off as China’s investment conditions improved over time. The promulgation of the

35. The nominal tax rate was 33% (consisted of 30% national and 3% local). For an overview of the tax implications for foreign investors, see Stephen C. Curley & Darren R. Fortunato, *Tax Considerations for Investors in China: A Preliminary Look*, 20 N.C. J. Int’l L. & Com. Reg. 531 (1995); Jinyan Li, *Tax Implications of Doing Business in China*, 43 Canadian Tax J. 75 (1995); and Kenny Z. Lin, *Income Taxation and Foreign Direct Investment in China*, 25 Int’l Tax J. 78 (1999).

36. See Jiang, *supra* note 17, at 580-9.

37. *Id.*

38. *Id.*

39. As discussed below, such differential policy resulted in round tripping. However, round tripping was presumably not considered a serious problem because China did not make it too difficult for those who did the round tripping. The alternative would have been applying tax incentives to all taxpayers, which would be costly in terms of revenue.

Enterprise Income Tax (EIT) Law⁴⁰ on March 16, 2007 officially declared the end of the existing FDI tax incentive regime.⁴¹

III. EFFECTIVENESS, EFFICIENCY AND EQUITY IMPLICATIONS OF TAX INCENTIVES

A. Overview

The tax incentives available to FDI are clearly in the nature of tax expenditures.⁴² They are assessed below in terms of the associated revenue loss, their effectiveness in attracting FDI to China, and their efficiency and equity implications in China.

For the purposes of this assessment, Chinese tax incentives are grouped into the following categories: tax holidays,⁴³ tax rate reductions in special areas⁴⁴ or for profit from specified activities,⁴⁵ and refund for reinvestment in

40. Enterprise Income Tax Law of the People's Republic of China, (EIT Law) promulgated by the National People's Congress, Mar. 16, 2007. This law replaces the two existing enterprise income taxes as of Jan. 1, 2008. The Chinese text of the law is available at the State Administration of Taxation web site: www.chinatax.gov.cn. An unofficial English translation is available at www.kpmg.com.cn and www.lehmanlaw.com. For a discussion of this new law, see Jinyan Li, *Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes*, (69) *Bulletin for International Fiscal Doc.* (2007) 519.

41. The elimination of existing tax preferences and the increase in the general tax rate for foreign-investment enterprises (FIEs) were feared for discouraging FDI in China. To ease this fear, the new law allows existing FIEs to continue to pay as the lower rate of 15% or 24% until 2013 or to enjoy other types of tax preferences (such as tax holidays) until the specified time period is over. For existing FIEs that have not started enjoying the tax holidays because they have not yet made any profits, the tax holiday will start in 2008. In addition, State Council may decide to grandfather existing tax preferences for newly-established hi-tech enterprises that receive priority support from the State and are located in special zones (e.g. SEZs, Pudong New Area in Shanghai, etc.), as well as tax preferential policies for enterprises the development of which is encouraged in certain regions (such as the Western Region). EIT Law, Article 57.

42. The seminal works on this topic are Stanley Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures*. Cambridge, MA. Harvard University Press (1973); and Stanley Surrey and Paul McDaniel, *Tax Expenditures*. Cambridge, MA. Harvard University Press (1985).

43. The standard tax holiday was three years (one year exemption and two years half reduction), starting in the first profit-making year. An extended holiday of ten years was available to FIEs engaged in low-profit operations in farming and forestry or located in remote, economically underdeveloped areas.

44. FIEs located in SEZs and some other special areas were taxable at a reduced rate of 15% (as opposed to the general rate of 30%). Local tax was waived. The tax holiday was extended to five years for "productive" enterprises (those

China.⁴⁶ They are all profit-based tax incentives and, as such, do not generally benefit the start-up companies that have losses in the initial stages, or innovative companies that incur significant research and development expenses. While most tax incentives were targeted at active business income, some were applicable to investment income, most of which was received by foreign investor in the form of dividends, interest or royalties.⁴⁷

Chinese tax treaties⁴⁸ generally preserve the effect of domestic incentives through a tax sparing clause. A tax sparing credit is found in treaties with most capital exporting countries (with the notable exception of the United States).⁴⁹ The effect of the tax sparing credit is that Chinese taxes waived or reduced under Chinese law⁵⁰ are deemed to have been paid for the purposes of

engaged in manufacturing, communication and transport, agriculture, forestry, and animal husbandry).

45. Additional tax incentives were available to export-oriented FIEs and technologically-intensive FIEs, whether or not they were located in a special area. On top of any tax exemption and reduction to which a taxpayer was entitled, the tax rate was reduced to 15% in general and 10% in SEZs. Reinvestment in either type of enterprises was eligible for a full refund of the tax paid on the reinvested profit. The tax rate was reduced to 10% for FIEs in ETDA's or other areas where the enterprise income tax rate was already 15%.

46. Tax is refunded to the investor if Chinese profits were reinvested in China. The general rate of refund was 40%. In certain special cases, the rate was raised to 100%. In SEZs, refund for reinvestment was 100% as opposed to 40%.

47. The nominal 20% withholding tax was reduced to zero on dividends (or distribution of profits) by FIEs, to zero or a lower rate for interest (mostly on loans extended to Chinese state-owned banks) and royalties paid in respect of transfer of advanced technology.

48. Since its first tax treaty with Japan in 1983, China has developed an impressive network of bilateral tax treaties (85 treaties by the end of 2006). These treaties generally follow the OECD Model Treaty and incorporate some elements of the UN Model Treaty in order to protect source-based taxation. For a list and text of China's treaties, see the State Administration of Taxation's website: <http://www.chinatax.gov.cn>. Because Hong Kong and Macao are "special administrative regions" and enjoy tax autonomy, Mainland China concluded a "tax arrangement" with each of special region to resolve any potential double taxation problem.

49. The tax sparing credit in some treaties has been phased out. For example, the phasing out of the tax sparing credit under the China-United Kingdom Treaty was provided under Article 5(1) of the Protocol concluded in 1996 to amend the China-UK tax treaty (1984).

50. A typical tax sparing credit clause makes specific references to the Chinese legislation that grants the tax reduction or exemption. Treaties concluded before 1991 refer to the EVJ Income Tax (1980) and the Foreign Enterprise Income Tax (1981) and similar subsequent provisions that are agreed by the competent authorities to be of a substantially similar character to those stipulated the treaty. The tax incentives granted under the FIE Tax (1991) have been considered to be of a substantially similar. Because the new Enterprise Income Tax Law (2007) retains the reductions and exemptions of

determining the credit available in the other treaty country. For example, under the China-Canada treaty,⁵¹ Chinese withholding tax on dividends is deemed to be 5% of the dividends paid even though the withholding tax rate is actually zero.⁵²

B. Revenue Loss

The direct cost of the FDI tax incentives is the amount of revenue loss. China has not published any official estimates on this cost or any other types of tax expenditures.⁵³ The amount is believed to be significant; one scholar thought the amount of revenue loss was as high as the amount of revenue collected.⁵⁴ In 2003, while FIEs contributed 33.4% of national industrial output, they paid only 20.9% of total taxes.⁵⁵

As discussed in more detail below, tax incentives also have indirect costs resulted from creating significant opportunities for illicit behaviour by tax

withholding tax on dividends, interest and royalties available under the 1991 tax law, it should be clear that the tax sparing credit applies to the new law.

51. For example, Article 21(2) of the China-Canada tax treaty: <http://www.chinatax.gov.cn/n480462/n480513/n481009/1017131.html>).

52. As far as Canadian tax is concerned, Chinese withholding tax on dividends is creditable only in cases where the dividends are paid out of “taxable surplus” as opposed to “exempt surplus.” Because China is a designated treaty country, dividends paid by FIEs to Canadian shareholders are mostly exempt dividends. As such, the tax sparing credit for dividends is of limited practical effect.

53. The Ministry of Finance is in the process of establishing a team of experts to study the issue of tax expenditures and develop models for assessments.

54. Quoqiang Ma, China’s Current Tax Expenditure System: Issues and Policy Options, in Hana Polackova Brix, Christian M.A. Valenduc, and Zhicheng. L. Swift, eds. *Tax Expenditures – Shedding Light on Government Spending Through the Tax System: Lessons From Developed and Transition Economies*. Washington D.C. The World Bank 190-202 at 197 (2004). Ma wrote that in terms of scale, “the cost of current tax expenditures has reached – and even exceeded – the amount of total tax revenue collected by the benchmark system. ... The cost of income tax expenditures exceeds the amount of income tax revenue.” Chinese scholars have increasingly argued that the tax incentive regimes in China are generous to a fault. See for example, Chun Chen, *Thoughts on China’s Foreign Tax Incentives*, no.7 *Int’l Taxation in China* 31-33 (in Chinese) (2005); Zhiyuan Li, *Building A Tax Expenditure System Suitable for China*, No.3, *Taxation Research J.* 40-42(in Chinese) (2006); Jiansuo Lu, *A Brief Discussion on the Sources of and Preventive Measures for Tax Revenue Loss*, No. 9 *Tax Research J.* 61-64 (in Chinese) (1999); and Zhiqiang Tang, *Defects and Adjustments of Foreign Tax Incentives*, No.10 *Int’l Taxation in China* 26-27 (in Chinese) (2005); and Jun Ye, *Discussion of the Need to Keep or Abolish Foreign Tax Incentives*, no.11 *Int’l Taxation in China* 28-29(in Chinese) (2005).

55. Xue Sun, *Possible Delay of Consolidating Enterprise Income Tax Laws to 2007*, 21st Century Economics Tribune (January 10, 2005) at 6. See also SAT website for the tax statistics: www.chinatax.gov.cn (in Chinese).

administrators and taxpayers. The loss of economic efficiencies due to the discriminative tax treatment of local businesses and barriers to fair competition is also expected to be significant.

C. Effectiveness in Attracting FDI

There is a rich body of literature examining the factors that may affect an investor's decision as to where to invest.⁵⁶ According to the surveys of investors in the 1960s to 1980s, "tax exemption is like a dessert; it is good to have, but it does not help very much if the meal is not there."⁵⁷ In other words, tax incentives are relevant, but not significant factors. At the same time, a survey of government officials ranked tax incentives as key factors in attracting FDI.⁵⁸ Evidence from the mid-1980s to the end of 1990s showed, however, that tax incentives "do affect the locational decisions of *some* investors *some* of the time."⁵⁹ Tax incentives are considered to have "a small but significant" influence in attracting FDI to developing countries.⁶⁰

56. For an overview of the literature, see Paul R. McDaniel, *The U.S Tax Treatment of Foreign Source Income Earned in Developing Countries: A Policy Analysis*, 35 *Geo. Wash. Int'l L. Rev.* 265 (2003); Yoram Margalioth, *Tax Competition, Foreign Direct Investments and Growth: Using the Tax System to Promote Developing Countries*, 23 *Va. Tax Rev.* 161 (2003); Avi Nov, *Tax Incentives to Entice Foreign Direct Investment: Should There Be a Distinction Between Developed Countries and Developing Countries?* 23 *Va. Tax Rev.* 685 (2004); – *The Bidding War* to Attract Foreign Direct Investment: The Need for a Global Solution, 25 *Va. Tax Rev.* 835 (2006). For economic literature, see David Wheeler & Ashoka Mody, *International Investment Location Decisions: The Case of U.S. Firms*, 33 *J. Int'l Econ.* 57. (1992); James R. Hines reached a contrary conclusion: *Tax Policies and the Activities of Multinational Corporations* 8 (Nat'l Bureau of Econ. Research, Working Paper No. 5589, 1996). See also Michael P. Devereaux & Harold Freeman, *The Impact of Tax on Foreign Direct Investment: Empirical Evidence and the Implications for Tax Integration Schemes*, 2 *Int'l Tax & Pub. Fin.* 86 (1995); Mihir A. Desai & James R. Hines Jr., *Foreign Direct Investment in a World of Multiple Taxes* 8 (Nat'l Bureau of Econ. Research, Working Paper No. 8440, 2001).

57. Jacques Morisset and Neda Pirnia, *How Tax Policy and Incentives Affect Foreign Direct Investment: A Review*, The World Bank and International Finance Corporation Foreign Investment Advisory Service (December 2000), at 5.

58. *Id.*

59. *Id.*

60. See A.J. Easson, *Tax Incentives for Foreign Direct Investment, Part I: Recent Trends and Countertrends*, 55 *Bull. For Int'l Fiscal Documentation* 266 (2001); A.J. Easson, *Taxation of Foreign Direct Investment: An Introduction* (The Netherlands, Kluwer) (1999); and McDaniel, *supra* note 56.

China has experienced a tremendous growth in FDI inflow during the past three decades and⁶¹ is the largest recipient of FDI among developing countries. During the same period of time, China has offered generous tax incentives to FDI.⁶² These two facts tend to lead to the conclusion that China's tax incentives seemed to have played a crucial role in attracting foreign investment.⁶³ Most Chinese scholars consider tax incentives to be a relevant factor.⁶⁴ Some Chinese scholars⁶⁵ attribute the huge leap in the early 1990s, in part, to the codification⁶⁶ of the existing tax incentives and the uniform treatment of all forms of FDI.⁶⁷ International scholars generally share this

61. The annual value of FDI actually utilized in China is listed as follows: 4.1 billion U.S. dollars in 1979-84, 1.9 billion U.S. dollars in 1985, 34.8 billion U.S. dollars in 1990, 37.5 billion U.S. dollars in 1995, 40.7 billion U.S. dollars in 2000, and 60.3 billion U.S. dollars in 2005. Source: China statistical Year Book (2006): <http://www.stats.gov.cn/tjsj/ndsj/2006/html/R1814E.xls>, visited on July 10, 2007.

62. United Nations, World Investment Report 2006 (New York and Geneva 2006), http://www.unctad.org/en/docs/wir2006_en.pdf.

63. Michael Littlewood, Tax Competition: Harmful to Whom? 26 Mith. J. Int'l L. 411 (2004-5) at 475. See also Francesco D'Muri and Anna Marenzi, Tax Systems and Tax Reforms in South and East Asia: Features and Effectives of Corporation Taxation on FDI (July 2005), available at <http://www.unipv.it/websiep/wp/409.pdf> (visited Sept. 1, 2007), at 27.

64. See, for example, Gang Li and Guangyi Chen, Direction of Chinese International Tax Law under WTO Principles, in Jianwen Liu, ed. Finance and Tax Law Rev. Vol. 8. Beijing, China: Law Press China, (2006) 281, at 298 (in Chinese).

65. See Changjie Xia and Zhu Li, Tax Incentives and FDI: Theoretical Analysis and China's Experience, No. 9 International Taxation in China, 53 (in Chinese) (2004).

66. Other favourable tax developments include the conclusion of a bilateral tax treaty over 40 countries that are the main sources of FDI in China, including Japan (1983), the United States (1984), France (1984), the United Kingdom (1984), Belgium (1985), Germany (1985), Malaysia (1985), Norway (1986), Denmark (1986), Singapore (1986), Finland (1986), Canada (1986), Sweden (1986), New Zealand (1986), Thailand (1986), Italy (1986), The Netherlands (1987), Poland (1988), Australia (1988), Switzerland (1990), Cyprus (1990), Spain (1990), Romania (1991), Austria (1991), Brazil (1991), Luxembourg (1994), Korea (1994), India (1994), Mauritius (1994). This list of tax treaties is posted on the SAT's website: www.chinatax.gov.cn.

67. In China, tax legislation includes tax "laws" ("fa lu") enacted by the National People's Congress (the legislature), "administrative regulations" (fa gui) promulgated by the State Council (the government branch), as well as administrative rules introduced by the State Administration of Taxation (SAT), which is a ministry of the State Council. From the beginning of economic reforms, China has tried to promulgate "laws" to govern FDI and other international activities. Examples are the Joint Venture Law (1979) and the Joint Venture Income Tax Law (1980). In contrast, domestic activities are regulated by "administrative regulations" or "administrative rules." Examples are those governing the tax incentives for SEZs and other special areas until 1991. Codifying these tax incentive measures into a "law" symbolizes the maturity

assessment. For example, Tseng and Zebregs⁶⁸ list preferential investment policies (including tax preferences) among the factors that have been most important in influencing FDI in China.⁶⁹ Tung and Cho went further, arguing that tax incentives are effective in attracting FDI to China.⁷⁰ There is also an apparent correlation between FDI and the Chinese location-specific and activity-specific tax incentives.⁷¹ Over 70% of FDI has been in manufacturing.⁷² In 2005, 58.3% of total export was by enterprises receiving FDI (i.e., foreign investment enterprises or FIEs).⁷³ Over 80% of FDI in China was invested in the coastal areas.⁷⁴ It is likely that most FDI projects enjoy some tax incentives.

However, using the FDI growth as a basis for asserting the effectiveness of tax incentives is unreliable as it fails to identify the amount of FDI inflow that would not have occurred in the absence of the tax incentives. On the other

of government policy, and thus creates more confidence of taxpayers in the certainty of the measures.

68. Wanda Tseng and Harm Zebregs, *Foreign Direct Investment in China: Some Lessons for Other Countries*, IMF Policy Discussion Paper PDP/02/03 (2003), available at <http://www.imf.org/external/pubs/ft/pdp/2002/pdp03.pdf>.

69. For a similar conclusion, see Leonard K. Cheng and Yum K. Kwan, *What are the Determinants of the Location of Foreign Direct Investment? The Chinese Experience*, (E. Asian Bureau of Econ. Research, Working Paper No. 174, 2000), available at http://www.eaber.org/intranet/documents/23/174/CUHK_Cheng_99_5.pdf.

70. Samuel Tung and Stella Cho, *The Impact of Tax Incentives on Foreign Direct Investment in China*, 9(2) *J. of Int'l Accounting, Auditing & Tax'n* 105-135 (2000). See also Littlewood, *supra* note 63.

71. Guangping Lei, *Implications of Enterprise Income Tax Reform for Utilization of FDI*, No.4, *Tax'n Res. J.* 35 at 36 (in Chinese) (2006). See also Zhang and Liu, *infra* note 85; and Xia and Li, *supra* note 65.

72. See *China Statistics Year Book* (2006), available at <http://www.stats.gov.cn/tjsj/ndsj/2006/html/R1817E.xls>, (last visited Jan. 14, 2008).

73. *Id.* In comparison, the share of total industrial output by FIEs was less than 35% of the national industrial output, which means that FIEs export more than Chinese-funded enterprises. See Jean-Claude Berthelemy and Sylvie Demurger, *Foreign Direct Investment and Economic Growth: Theory and Application to China*, 4 *Rev. Dev. Econ.* 140 (2000).

74. Xiaojuan Jiang, Yingxin Wang, and Laike Yang, *A Study of the Gradual Shift of Foreign Investment*, *Chinese Econ.* Sept.-Oct. 2004, at 19, 19-24. Chen, Chun *Reflections on the matter of Foreign Tax Preferences*, No.7 *Int'l Tax'n China* 31-33 (in Chinese) (2005). On the other hand, there are obvious non-tax factors that are attractive to FDI: the special areas in the East Coast generally have a longer history of open to investors, better infrastructure, more open, transparent and efficient local government, better educated workforce and higher purchasing power. Tai-Yuen Hon, Che-Cheong Poon & Kai-Yin Woo, *Regional Distribution of Foreign Direct Investment in China: A Multivariate Data Analysis of Major Socioeconomic Variables*, *Chinese Econ.* Mar.-Apr. 2005, at 56 (a fundamental determinant of regional disparity in FDI in China during 1998-2003 was the overall socioeconomic environment in the administrative regions).

hand, there is no available data showing the relevance of various factors, including tax incentives, in influencing the locational decisions of foreign investors. It seems that more weight was given to tax incentives than what actually happened. For example, the Shanghai Pudong experience has been offered as proof that tax incentives worked, while in fact almost all the real investment in terms of factories was outside the Pudong zone and paid no Chinese tax anyway as a result of transfer pricing.⁷⁵ The apparent correlation between the location of FDI in China's coastal areas and the location-specific tax incentives is also misleading as evidence of the effectiveness of tax incentives. The general investment environment in coastal areas has been more inductive to investment than the rest of China. Since most exports are competitive on labour costs and low-level of regulation regarding pollution, labour protection, health and safety controls, it's possible that labour-intensive, export-oriented investment would have taken place anyway.

According to a survey of companies in the European Union about the factors influencing their decision to invest in China,⁷⁶ 91% of investors put investment incentives on medium or higher position when deciding to invest, and 41% considered incentives as highly important factors.⁷⁷ To the extent that tax incentives influence a foreign investor's decision, the influence seems to vary in terms of the time of investment, origin of the FDI, the size of the investor, and the investor's strategy in China.⁷⁸

Early years – Generally speaking, tax incentives were more relevant during the early years when the signalling, compensation and cultural effect was most evident. Once the tax incentive regime was firmly in place, it became a constant factor and had much less influence. For example, following China's accession to the WTO in 2001, the fate of FDI tax incentives was publicly debated in China,⁷⁹ but, in spite of the uncertainty and possible elimination of the incentives, FDI continued to increase in China.

Home country taxation – In terms of the origin of FDI, Chinese tax incentives are more attractive to investors based in low-tax jurisdictions. These investors stand to benefit from the Chinese tax incentives as Chinese tax is the

75. This example is based on conversations between Rick Krever and Chinese tax officials while during one of his trips to China.

76. Wenhua Shan, *Law and Foreign Investment in China: General Role of Law and Substantive Issues (Part One)*, *Manchester J. Int'l Econ. L.* Issue 3 (2005) at 41.

77. *Id.*, at 54.

78. This is consistent with the finding by Easson that once a multinational enterprise has decided to invest in a given region, then tax incentives can influence the location of the FDI within the region; Easson (2001), *supra* note 60, at 267.

79. Li and Chen, *supra* note 64; Hong Guo, *Principles and Directions of China's Foreign Tax Incentives*, No. 11 *Tax Res. J.* 14-18 (in Chinese) (2005); Guoqiang Ma, *Current Chinese Tax Incentives: Problems and Suggestions*, *Tax Res. J.* 34-38 (in Chinese) (2003); Jiang Liang, *Problems with China's Current Tax Incentives for Science and Technology*, No. 10, *Tax Res. J.* 35-38 (in Chinese) (2001).

only tax payable. But of course, some low-tax countries (such as Samoa and British Virgin Islands) act as funnels for capital from high-tax developed countries. As we will explain below, tax havens have been used by Chinese investors for round-tripping funds. To that extent, there has been no increase in investment but mere recharacterisation of the source to avoid Chinese tax.

Investors from “exemption” jurisdictions seem to react more positively to Chinese tax incentives than those from “credit” jurisdictions.⁸⁰ For example, companies from continental Europe (typically with exemption system that does not tax foreign-source business income) place higher importance on incentives than their counterparts in the United Kingdom (a credit system).⁸¹ Investors from credit jurisdictions, especially those that do not grant tax sparing credit (notably the United States) maybe indifferent to the Chinese tax incentives if they have to distribute profits to the United States⁸² or channel their FDI through a tax haven entity.⁸³ It is possible that a portion of the FDI from Japan is attributable to the tax sparing credit under the China-Japan tax treaty.⁸⁴

Size of investors – Large multinational enterprises are found to be less influenced by Chinese tax incentives than small and medium sized firms.⁸⁵

80. For a case study of the relevance of home country taxation, see Chad Leechor and Jack M. Mintz, *Taxing Foreign Income in Capital-Importing Countries: Thailand's Perspective*, (Country Econ. Dep't, The World Bank, Working Paper No. WPS-0499, 1990), available at <http://go.worldbank.org/B6U0YYHSXO>. See Timonhly J. Goodspeed, *Taxation and FDI in Developed and Developing Countries* (2004), available at <http://isp-aysps.gsu.edu/academics/conf2004/Goodspeed.pdf>. (last visited Jan. 15, 2008) (reviewing the literature on the theoretical incentive effects of host-country taxes on FDI coming from tax credit countries).

81. Shan, *supra* note 76, at 55.

82. There seems to be only very a small difference in the impact of investment incentives resulting from territorial versus worldwide system. See Goodspeed, *supra* note 80.

83. Lei, *supra* note 70, at 36.

84. For further research, see Celine Azemar and Andrew Delios, (2005); *Fiscal Incentives in Developing Countries and FDI: Tax Sparing Matters* (Apr. 2005), available at http://www.afse.fr/docs/congres_2005/docs2005/Azemar.pdf (visited Nov. 16, 2007); Celine Azemar, Rodolphe Desbordes and Jean-Louis Mucchielli, *Do Tax Sparing Agreements Contribute to the Attraction of FDI in Developing Countries?*, available at <ftp://mse.univ-paris1.fr/pub/mse/cahiers2004/Bla04047.pdf>; James Hines, Jr., *Tax Sparing and Direct Investment in Developing Countries*, Nat'l Bureau Econ. Research Working Paper No. 6728 (1998), available at <http://www.nber.org/papers/w6728>.

85. Yang Zhang and Hui Liu, *Analysis of the Impact of Taxation on FDI*, No. 4, *Tax'n Res. J.* 39 at 41 (in Chinese) (2006). Shan, *supra* note 76, also made this conclusion in his empirical study. Shan notes that tax incentives were regarded as an important FDI location factor on the basis of the number of investors surveyed. However, the “widely held assumption that western investors do not care much about incentives” remains valid as it reflects the opinions and experiences of large multinationals, which accounts for the vast majority among international investors in

Presumably, multinationals are more interested in the long-term investment environment than the short-term effect of tax incentives. They can use tax planning techniques to achieve an effective tax rate target which is much lower than the formal tax rate. Large multinational companies are also more likely to receive special tax treatments because of their bargaining positions. Small investors are generally more responsive to tax incentives.⁸⁶

Business strategy in China – Investors who are lured to China by its domestic market, such as retail, telecom, banking, services, and certain consumer products are less affected by tax incentives. FDI in the extractive sectors is located in China because of the natural resources. “Real” long-term investment in human capital and technological innovation rather than assembly manufacturing does not generate immediate taxable income so tax holidays or tax rate reductions have no effect on it. In fact, the lion’s share of FDI in car manufacturing or other types of long-term -projects are not actually located in the special areas that benefit from tax incentives, but in places where there is a strong existing manufacturing base (Tianjin, Wuhan, Shanghai, Shenyang, and Chongqing).⁸⁷ In contrast, investors looking for low-cost manufacturing bases tend to react more positively to Chinese tax incentives. For example, most investors from Hong Kong and Taiwan invest in these types of projects and considered tax incentives an important factor.⁸⁸

D. Efficiency and Economic Development

There appears to be two normative arguments about the efficiency of FDI tax incentives. First, tax incentives distort behaviour and are thus inefficient.⁸⁹ Second, tax incentives are not inefficient as long as they overcome market failures and compensate foreign investors for positive externalities.⁹⁰

terms of the amount of their investment, but a tiny minority in terms of their number. Id. at 55.

86. For studies on this topic, see E.J. Coyne, *An Articulated Analysis Model for FDI Attraction into Developing Countries*, Florida; Nova Southeastern University (1994), reviewed by Morisset and Pirnia, *supra* note 57.

87. See David Bartlett, *China’s rise as a global manufacturing power*, GEC Executive Brief, May 2003, at <http://globaleconomics.net/graphics/ChinaMFG.pdf>.

88. Kevin Honglin Zhang, *Why Does so much FDI from Hong Kong and Taiwan go to Mainland China?* (16) *China Economic Rev.* 293-307 (2005).

89. See UN, *The Determinants of Foreign Direct Investment: A Survey of the Evidence*, U.N. Doc. ST/CTC/121, UN. Sales No. E.92.II.A.2. (1992); *Tax Incentives and Foreign Direct Investment: A Global Survey* U.N. Doc. CTAD/ITE/IPC/Misc. 3, U.N. Sales no. E.01.II.D.5 (2000); OECD, *Taxation and Foreign Direct Investment: The Experience of the Economies of Transition*. Paris, OECD (1995). Economists tend to argue that state intervention in the form of tax subsidies distorts the efficient allocation of resources through price and market mechanisms. For a survey of these views, see Margalioth, *supra* note 84; and Nov. (2006), *supra* note 56, at 842-4.

90. Margalioth, *id.*, at 182.

The second argument is more persuasive in the Chinese context. FDI tax incentives aim at influencing foreign investors' decision in order to attract investment to China. Since "tax incentives are meant to distort behaviour,"⁹¹ they are deliberate violations of neutrality. Like other types of tax expenditures, it is inappropriate to evaluate FDI tax incentives under the normative theory of neutrality or efficiency. Instead, efficiency is better assessed by examining the type of investors' behaviour induced by the incentives and the extent to which the incentives worsen, as opposed to, overcome market failures.

Positive externalities of FDI – FDI tax incentives were intended to attract FDI that would not have come to China otherwise. To the extent that the FDI attracted by tax incentives entails positive externalities,⁹² the incentives are efficient. Positive externalities of FDI in general are much in evidence. FDI has been considered to be the "engine" of China's rapid economic growth: FIEs contributed to about 0.4 percentage points to China's annual GDP growth during the 1990s,⁹³ helped China build a highly competitive and dynamic manufacturing sector for exports,⁹⁴ and affected China's economic growth through the diffusion of idea and transfer of technology.⁹⁵ The jobs created by FIEs in urban areas quadrupled between 1991 and 1999 to a total of 6 million, accounting for 3% of China's urban employment.⁹⁶ Because FDI was an important source of China's economic growth, it is a powerful force for general poverty reduction in China.⁹⁷

As discussed above, however, it is unclear as to the extent of FDI that was actually attracted by tax incentives. It is thus difficult to ascertain how efficient tax incentives are. Meanwhile, the choice of tax incentive instruments and the difficulties of administering these instruments in a transitional economy provide investors with opportunities to take advantage of, or abuse, these tax incentives. To the extent that these FDI-specific tax incentives encourage tax avoidance or evasion without generating any real increase in economic activities, they clearly have a negative impact on the economy.

"Round tripping" – Chinese tax incentives have been granted only to "foreign" investors. As expected, this has resulted in a significant degree of "round tripping."⁹⁸ Chinese laws do not define "foreign" in any substantive manner. A company is "foreign" as long as its place of registration is outside

91. *Id.*, at 182.

92. *Id.*, at 183.

93. Tseng and Zebregs, *supra* note 68.

94. *Id.* See also Zhang Tao, Utilization of Foreign Capital and Economic Growth in China, vol. 37, no. 1 *The Chinese Economy* 62-84 (Jan.-Feb. 2004).

95. See Stephane Dees, Foreign Direct Investment in China: Determinants and Effects, 31 *Economics of Planning* 175-94 (1998).

96. Tseng and Zebregs, *supra* note 68.

97. Kevin Zhang, *supra* note 88.

98. Easson argued that such round-tripping may happen whenever tax incentives are given only to foreign investors: Easson, *supra* note 60, at 367.

Mainland China. Chinese investors, who would otherwise pay tax at least 10% higher than FIEs, have been motivated to engage in round tripping. The People's Daily⁹⁹ reported:

The British Virgin Islands is a major destination for China's offshore investment. ... 10,000 out of 500,000 companies there are from China. Most China-originated money entering tax havens will re-enter China as "foreign investment," – "round tripping." ... A closer examination of China's star foreign direct investment (FDI) figures reveal a large amount of capital going out of the country and returning under a different guise. The World Bank and other experts have estimated the scale of this round tripping could be as large as 20% to 30% of the total FDI inflow into China, but there is no clear definition and detailed estimation method behind the numbers. ... Even worse is that the trend is growing bigger. ... The biggest pay-off for recycling mainland-originated money through a web of companies offshore is the tax concessions that China grants to foreign firms.

Round tripping clearly distorts the investment behaviour of Chinese investors. Since the capital is originated from China, the positive externalities expected of genuine FDI could not occur.¹⁰⁰ Moreover, round tripping makes a mockery of the Chinese tax system by circumventing the law in a "glorified" manner. Round tripping also distorts data on FDI in China, which may not only influence the effectiveness and official management of China's FDI utilization, but also bring risks to China's financial system.¹⁰¹

Perennial losses or "footloose" investors – The tax holiday for "new" FIEs starts in the first year of making a profit. Chinese researchers found that many FIEs postpone reporting a profit in China by "surplus stripping" techniques (such as paying royalties, management fees and excessive interest

99. China Daily, Investment outflows to tax havens, People's Daily Online, Jun. 22, 2004, http://english.peopledaily.com.cn/200406/22/eng20040622_147138.html (visited Jul. 31, 2007).

100. The World Bank and other agencies and experts have estimated that the scale of this round tripping could be as high as a quarter of the total FDI inflows into PRC: World Bank (2002), Global Development Finance 2002, available at www.worldbank.org. For more discussion, see Geng Xiao, Round-Tripping Foreign Direct Investment in the People's Republic of China: Scale, Causes and Implications, at <http://www.adbi.org/discussion-paper/2004/06/01/450.prc.foreign.direct.investment> (2004) (visited Jul. 31, 2007).

101. China Daily, *supra* note 99.

to foreign related companies) or transfer pricing.¹⁰² In this way, the FIE can use the tax holiday when the profit and income tax are significant. Otherwise, the tax holiday would begin in the first-year of profit, irrespective of the amount of tax saved.

Tax holidays begin as soon as a FIE taxpayer becomes profitable and expire at the end of the specified period. They primarily benefit short-term investments, which often are undertaken by “footloose” companies that quickly disappear from one location to reappear in another. The tax holidays also tend to reward the establishment of a FIE, rather than investment in an existing enterprise. Chinese researchers found that many FIEs terminate an investment in order to start a “new” investment as soon as the tax holiday is over.¹⁰³ About one quarter of all FIEs registered since 1979 were believed to have paid no income tax because, among others, the investment was terminated after the tax holiday.¹⁰⁴ This, in part, explains the somewhat puzzling phenomenon that foreign companies keep investing in China “irrespective of short-term profitability.”¹⁰⁵ The transaction costs associated with open and close of FIEs have no economic benefits other than saving taxes.

Administrative inefficiencies – There are efficiency costs associated with the administration of FDI tax incentives. It is widely recognized in China that FDI tax incentives are misused and abused at local levels.¹⁰⁶ Tax incentive legislation provides a great deal of discretion to local tax authorities to approve tax incentives.¹⁰⁷ The lack of transparency and accountability in administering

102. See, for example, Chunshan Wu, *The Use of Tax Havens and Their Prevention*, No.10, *Int'l Taxation in China*, 25-26 (P.R.C.) (1998); and Jun Ye, *An Examination of the Reasons for Keeping or Abolishing FDI Tax Incentives*, No.11, *Int'l Taxation in China* 28-29 (P.R.C.) (2005).

103. Wu, *id.*; and Wei Tie, *An Evaluation of the Causes for Tax Avoidance under Current Law*, No.11, *Int'l Taxation in China* 32-34 (P.R.C.) (1999).

104. Sun, *supra* note 55. This is consistent with international evidence on the use of tax holidays; see Morisset and Pirnia, *supra* note 57, at 12-13.

105. Littlewood, *supra* note 63, at 476.

106. See, for example, Tingxu Li, *Means of Tax Avoidance and Tax Evasion by Foreign Investment Enterprises and Prevention Measures*, No.8, *Int'l Tax J. of China* 62-64 (P.R.C.) (1999); Wei Tie, *Causes and Assessment of Tax Avoidance under Current Tax System*, No.11, *Int'l Taxation in China* 32-34 (P.R.C.) (2005); and Jun Ye, *To Repeal or Not to Repeal of Foreign Tax Incentive Policies*, No.11, *Int'l Tax J. of China* 28-29 (P.R.C.) (2005).

107. For example, Article 8 of the 1991 FIE and Foreign Enterprise Income Tax Law states: “Any enterprise with foreign investment which is engaged in agriculture, forestry or animal husbandry and any other enterprise with foreign investment which is established in remote underdeveloped areas may, upon approval by the competent department for tax affairs under the State Council of an application filed by the enterprise, be allowed a 15% to 30% reduction of the amount of income tax payable for a period of 10 years ...”

tax incentive legislation tend to lead to graft, corruption and rent seeking.¹⁰⁸ Local governments have also engaged in fierce tax competition by lobbying the Central Government for more tax preferences.¹⁰⁹

Market Failures and tax discrimination – China introduced FDI tax incentives to, in part, compensate investors for the lack of market or investment conditions. During the early years of reform, these incentives played a positive role in attracting investment, which, in turn, promoted the development of a market mechanism in China and propelled economic growth. In this sense, the tax incentives were efficient, but only as long as the FDI was separate from domestic enterprises. The dual track system was the product of China's evolutionary approach to economic reforms. The domestic track was evolutionary, allowing gradual reform of state-owned enterprises and the creation of a market mechanism.¹¹⁰ During the early periods of economic reforms, there were significant market failures and the internal tax policy had strong traits of the command economy. FIEs were regulated more by market principles than government plans. Direct competition with local enterprises on the Chinese market was limited.

The dual track system was difficult to maintain when FIEs were allowed greater access to the Chinese internal market, especially after China's accession to the WTO in 2001. Foreign firms have been gradually allowed to own up to 50% of enterprises in sensitive industries, such as telecom, banking and insurance industries. Multinational companies have taken over Chinese companies in a quest for economies of scale. The FDI tax incentives have aided such foreign take-overs. In 2006, foreign investors controlled the majority of

108. See Shang-Jin Wei, Does Corruption Relieve Foreign Investors of the Burden of Taxes and Capital Controls? (The World Bank Dev. Research Group, Working Paper No. 2209, 1999). Zdenek Drabek & Warren Payne, (The Impact of Transparency on Foreign Direct Investment,) (World Trade Org. Econ. Research and Analysis Div., Working Paper No. 99-02.

109. Li and Chen, *supra* note 64; Jiang Liang, China's current Tax Preferences of High-Tech and the Problems, No.10, Tax Research J. 35-38 (P.R.C.) (2001).

110. This policy seemed to have contributed positively to the success of economic reforms at earlier stages. The domestic track was considered highly successful in complementing the structural reforms of state-owned enterprises (SOEs). A main goal in internal economic reforms was to restructure SOEs to become economically efficient entities. Replacing the previous profit-delivery mechanisms under the command economy with tax payments helped SOEs and their government regulators to recognize the new relationship between the enterprises and the government. It also provided economic incentives for SOEs to be more profitable as they can keep the after-tax profits. The tax system brought some "objective" assessment of the performances of SOEs. Another goal in internal economic reforms was to gradually allow the development of the private sector, which was previously viewed suspiciously in ideological terms. By taxing the profits of private enterprises, the government legitimized the private sector.

assets in 21 out of 28 major industrial sectors.¹¹¹ Given the large amount of FDI in China, domestically-funded companies are facing tax discrimination in addition to the challenges resulting from multinational firm's control and market power on the Chinese market. The potential dominance of key economic sectors by multinational firms, assisted by the tax system, became a serious concern.¹¹² Chinese-owned enterprises started to cry for "national treatment" from their own government. The Minister of Finance, Jin, Renqing, acknowledged this in his explanation of the draft law to the National People's Congress.¹¹³

Great changes have taken place in China's economy and society, and the socialist market economy has initially taken shape. With China's accession to the WTO, the Chinese domestic market has been further open to foreign capital; domestic enterprises have gradually integrated themselves into the world economy and are facing ever-increasing competition. If different tax policies continued to be implemented for domestic and foreign-funded enterprises, the former would definitely be put at a competitive disadvantage and the establishment of a unified market with standardized and fair competition would be obstructed.

Therefore, FDI tax incentives that had the effect of overcoming market failures in the late 1970s and 1980s became barriers to market-based competition in the late 1990s and 2000s. With the gradual improvement in market conditions, the incentive measures became less efficient.

E. Equity in China

Compared to the efficiency aspect of FDI tax incentives, the equity and redistribution effect of FDI tax incentives has received much less attention in tax literature.¹¹⁴ In theory, the redistributive effect of FDI tax incentives exists

111. Weigan Shi, A Reexamination of the Role of Foreign Investors (Sept. 1, 2006), available at: <http://finance.sina.com.cn> (P.R.C.).

112. See Hung-Gay Fung, Julius H. Johnson, Jr., and Yanda Xu, (Winners and Losers: Foreign Firms in China's Emerging Market,) *The Chinese Econ.* May, 2004, at 5-16.

113. Jin Renqing, P.R.C. Fin Minister, Explanation on Draft Enterprise Income Tax Law, The full text of the speech in English is available at <http://www.china-embassy.org/eng/gyzg/t302221.htm> (visited Jul. 31, 2007).

114. For a discussion of the equity aspect of tax competition, see Reuven S. Avi-Yonah, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 *Mich. J. Int'l L.* 371 (2004); Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 *Geo. L. J.* 543 (2001). For

if they result in shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption.¹¹⁵

In China's case, such redistributive effect is barely noticeable. China's tax structure has always relied on consumption taxes as a main source of revenue: the Value-added Tax (VAT) and other sales taxes generate more than two-thirds of total tax revenue; income taxes collected from enterprises and individuals generate about 22% of total tax revenue.¹¹⁶ The tax policy towards FDI has not affected the overall design of the Chinese tax structure. The tax structure in China cannot, by design, play a key role in alleviating inequality in income and wealth. In developed countries, personal income tax has been used as the main instrument for redistributing income.¹¹⁷ In China, the role of progressive personal income tax in redistribution remains largely symbolic at the moment; the Individual Income Tax¹¹⁸ is the only progressive tax in China, accounting for less than 6 % of total tax revenue.¹¹⁹

a critique of the role of Miranda Stewart and Sunita Jogarajan, *The International Monetary Fund and Tax Reform*, *British Tax Review* (2004) 146-175 (2004); and Miranda Stewart, *Global Trajectories of Tax Reform: The Disclosure of Tax Reform in Developing and Transition Countries*, 44 *Harv. Int'l L. J.* 134, 140-190 (2003).

115. These two aspects are listed as evidence of harmful effects of "preferential tax regimes" in the OECD Harmful Tax Competition Report. Paris, OECD (1998), ¶ 23.

116. Nat'l Bureau of Statistics of China, 2005. Beijing, China: Finance Press at <http://www.stats.gov.cn/tjsj/ndsj/2005/html/H0803e.htm>. The VAT and turnover taxes have some progressive features. For example, the Consumption Tax is imposed on luxury goods and services at progressive rates. This tax is presumably borne by high-income earners. The VAT is slightly progressive with a lower rate on certain necessities (e.g., grain and edible oil, running water). Overall however, these taxes worsen the urban/rural disparities as low-income rural residents much pay these taxes. In many poor rural areas, these taxes are the only taxes collected. See Tao Ran and Mingxing Liu, *Urban and Rural Household Taxation in China: Measurement, Comparison and Policy Implications*, (10) No.4 *J. of the Asia Pacific Economy* 486-505 (2005).

117. See Richard M. Bird and Eric M. Zolt, *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, (52) *UCLA L. Rev.* 1627 (2005).

118. The Individual Income Tax Law has been amended on October 31, 1993, Aug. 30, 1999, and Oct. 27, 2005.

119. This is not much different from the role of personal income tax in other developing countries. See Bird and Eric Zolt, *supra* note 117. Although still an insignificant source of revenue for the government, the amount of revenue increased rapidly: it grew by more than 6 times between 1980 (CNY0.1 million, accounting for less than 1% of total tax revenue) and 2004 (CNY173,700 million): see State Administration of Taxation, *Tax Statistics*, (Apr. 20, 2006), www.chinatax.gov.cn. It is progressive only with respect to employment income and business income as other types of income are taxable at a flat rate. The fraction of population paying the tax grew from 0.1% of all wage earners in 1986 to 32% of all wage earners in 2001 and

Chinese tax policy has not played any significant role in promoting social development or redistribution of income.¹²⁰ China's goal is to develop a "Xiaokang society" in which "people generally are not rich but have adequate food, clothing, and other material belongings necessary for a decent life."¹²¹ Economic development is a precondition for reaching this goal.¹²² The efficiency and economic growth objectives of tax policy have been largely divorced from the equity and redistribution objectives of tax policy. The FDI tax incentives cannot be blamed for failing to promote redistributive justice in China as they were not intended as such.

the average amount of annual tax paid by each wage earner was CNY314 (less than USD40) in 2002. More than one-third of the total IIT on employment income was collected from workers at FIEs. Given the current situations in China, the Individual Income Tax cannot be a meaningful tool of redistribution. For further discussion, see Thomas Piketty and Nancy Qian, *Income Inequality and Progressive Income Taxation in China and India, 1986-2001*, available at http://www.econ.brown.edu/fac/Nancy_Qian/Papers/PikettyQian2004.pdf (2004); Jinyan Li, *The Chinese Individual Income Tax: A 26-Year Old Infant*, 43 *Tax Notes Int'l*, 297; Hua Shi, *Changes in the IIT Revenue Composition*, No.4 *China Taxation* 4-6 (P.R.C.) (2004); *Frontier Tax Policy Study in China*, Beijing, China: China Taxation Press, at 344 (2003).

120. China has achieved social development in certain areas. For example, according to the United Nations report, China's human development index improved continuously in the past 20 years, from 0.557 in 1980 to 0.755 in 2003 and China's global ranking rose from 101st in 1991 to 85th in 2003. On the other hand, there have been increasing income disparities, regional disparities, and urban and rural disparities. For example, in 2002, per capita GDP in East China was CNY12,266, but only CNY5,144 in Southwest. Within the Southwest region, urban per capita GDP was CNY6,304, and rural per capita GDP was only CNY1,744. Women, children, and racial minorities are generally disadvantaged disproportionately.

121. United Nations Dev. Programme & China Dev. Research Fund. *China Human Development Report 2005*, available at <http://www.undp.org.cn> at 1.

122. This is not much different from the "Asian path" to development: Pareerboom (2005), *supra* note 9. In 2005, however, the new leadership put forward the concept of scientific development and the concept of harmonious society to guide reforms. This was the first time that China took a more comprehensive approach towards development. Social development is elevated to complement economic development. The concept of harmonious society stresses the need to reconcile conflicts between rural and urban areas and between different social groups to promote social stability. It is linked to the notions of social welfare and more equal income distribution and to the rule of law. This new comprehensive approach has not been reflected in tax policy. This part of the paper examines the relationship between tax policy and social development. Wen Jiabao, Premier of the State Council, Report on the Work of Government, Third Session, 10th National People's Congress and Chinese People's Political Consultative Conference, Mar. 5, 2005.

IV. INTERNATIONAL IMPLICATIONS

A. Overview

China's experiment with FDI-specific tax incentives presents some interesting issues for international tax debates. It is true that China is different from many other developing countries because of its sheer size: the world's largest recipient of FDI, fourth largest economy, and third largest trader.¹²³ As a market-maker, China is perhaps more capable of escaping the "prisoner's dilemma"¹²⁴ that smaller, open developing countries tend to fall victim to. Meanwhile, China has paid close attention to international tax norm and followed the advice of international experts when they are suitable to China's conditions.¹²⁵ The increasing integration of the Chinese economy with the world economy has made it increasingly important for China to care about tax policy of other countries and for other countries to care about China's. The implications of the Chinese experience are discussed below in terms of the choice of tax policy instruments in attracting FDI, harmful effects on other countries, and inter-nation equity and redistribution.

B. Choice of Tax Instrument for Attracting FDI

Tax policy matters – China's experience challenges "a widely held view that tax incentives of all sorts have proved to be largely ineffective, while

123. For a detailed discussion of FDI flows, see World Investment Report, <http://www.unctad.org/Templates/Page.asp?intItemID=1485&lang=1>

124. The prisoner's dilemma is a game theory. It is a type of non-zero-sum game in which two players may each "cooperate" with or "defect" (i.e. betray) the other player. In the classic form of this game, no matter what the other player does, one player will always gain a greater payoff by playing defect. Since in any situation playing defect is more beneficial than cooperating, all rational players will play defect. In the context of tax competition, this theory holds that even if all countries participating in the competition knows that they are collectively better off by cooperating with one another by refraining from granting tax incentives, no country wanted to do that for fear that other countries won't follow. So, every country chose to "defect." According to Shaviro, the number of articles in U.S. and Canadian law reviews mentioning prisoner's dilemmas was 837 over a five-year period ended in June 2006. See Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?* (N.Y.U. L. Sch. Law & Econ. Research Paper Services Working Paper No. 07-12; <http://www.rn.comabstract=966256> (2007).

125. In the late 1970s, when advised by international experts that granting tax incentives was not a good idea China ignored it. During early 2000s, when China's internal conditions require it, similar international advice became heeded to and FDI tax incentives were replaced with a general lower corporate tax rate.

causing serious distortions and inequities in corporate taxation.”¹²⁶ During the earlier years of Chinese reforms, FDI tax incentives were generally considered effective as they helped China overcome some investment hurdles (market failures and lack of ideal institutional investment environment), send a signal of welcoming foreign investment, and entice overseas Chinese to invest in China. As a temporary measure, FDI tax incentives played a role in jumping-start China’s economic development.¹²⁷ The overall effect, however, has been mixed. When domestic market conditions and institutional settings improved, the FDI tax policy became less effective and less efficient.

The Chinese experience also shows the importance of tax competition. In the age of globalization, the cross-border mobility of capital limits a country’s freedom in taxing capital. Even though tax-policy making remains a hallmark of national sovereignty, few countries can afford to ignore the international competitiveness of their tax policy.¹²⁸ China is no exception. To be competitive, China used FDI-specific incentives in the past and will use a generally lower corporate tax rate in the future.¹²⁹ A general low tax rate is, in itself, an incentive.¹³⁰

From FDI specific incentives to general low rate – The promulgation of the EIT Law that adopts an universal tax rate for all enterprises, irrespective of they receive FDI, represents a major shift in Chinese tax policy from a temporary, transitional mode to a mature, outward-looking mode. It moves the

126. Janet Stotsky, Summary of IMPF Tax Policy Advice, in Tax Policy Handbook 279, 282 (Parthasarathi Shome ed., 1995).

127. In this sense, China’s experience is generally consistent with that of Singapore. See Johan Deprez, The Telecommunications Industry in the Information Age: A Case Study in Globalization, Deregulation, and Tax Competition, 23 Loy. L.A. Int’l & Comp. L. Rev. 537 (2001); N. Jerold Cohen, ABA Members Comment on Runaway Plant Proposal, 96 TNT 150-31 (May 31, 1996); Terrence R. Chorvat, Book Review: A Different Perspective on Tax Competition, 35 Geo. Wash. Int’l L. Rev. 501 (2003); How Teck Tan, Singapore’s Tax Treaty Policy, 29 Intertax 184 (2001) (examining Singapore’s use of tax incentives).

128. H. David Rosenbloom, Sovereignty and the Regulation of International Business in the Tax Area, 20 Can.-U.S. L.J. 267 (1994). No area of the law is closer to the subject of sovereignty than taxation. As long as diversity of culture, economy, political and fiscal factors leads countries to pursue a wide range of income tax systems, countries will try their best to preserve their tax sovereignty. For a further discussion on the implications of globalization for tax policy, see John P. Steines, Jr., Income Tax Implications of Free Trade, 49 Tax L. Rev. 675 (1994).

129. See Margalioth, *supra* note 56; Ireland is often cited as a success story with its generally low corporate tax rate. The OECD also makes a distinction between tax competition in the form of generally applicable lower tax rates and tax regimes designed to attract FDI: OECD 1998 and OECD 2000, *infra* note 178.

130. Moriset and Pirnia, *supra* note 57, at 12.

Chinese tax system closer to international tax norm.¹³¹ Tax neutrality is one of the important principles underlying the reform.¹³² Several domestic and international factors seem to have influenced China's decision to abolish FDI tax incentives and to adopt a generally lower corporate income tax rate.

Domestically, the Chinese government decided in 2005 to upgrade China's economic development model from that of FDI-led manufacturing and export to one of a technology-driven, sustainable economic development.¹³³ The existing tax incentives were geared to promote the former model of development and were thus outdated. By 2007, the Central Government's fiscal position had been relatively strong to afford the general reduction of corporate tax rate. The increasing integration of FDI with the domestic economy made it very difficult for the government to justify preferential tax policy towards FDI. There were also serious doubts about the effectiveness of tax incentives in attracting "real" foreign investment to China that help China develop a sustainable economy.

Internationally, China's accession to the WTO had tremendous impact. Because China must allow foreign investors to have access to the Chinese market, domestic enterprises were exposed to international competition and were at risk of losing out to multinational corporations. The FDI tax incentives further aid foreign companies in competing with Chinese companies. Such "supra national treatment" was certainly not required by the WTO. Chinese businesses seized the opportunity to lobby the government to end tax discrimination. Another source of international influence is Ireland's economic success.¹³⁴ Adopting the Irish model will "kill two birds with one stone" by ending tax discrimination against domestic companies and maintaining China's

131. Jin, *supra* note 113. In explaining the draft law to the National People's Congress, the Minister of Finance identified the following as guiding principles for the new law: equal taxation of all enterprises at the rate of 25%; the promotion of overall, sustainable development of the Chinese economy, reference to international tax norm and practices; and efficiency tax administration and simplicity in compliance. *Id.*

132. The principle of capital export neutrality is reflected by retaining the system of worldwide taxation and foreign tax credit mechanism, as well as introducing new anti-deferral rules under Article 45 that are targeted at low-tax jurisdictions. For the first time, China introduced a general anti-avoidance rule in Article 47 to supplement the specific international anti-avoidance rules, such as transfer pricing (Article 41) and thin-capitalization rules (Article 46).

133. For an overview of this policy shift, see John Whalley and Weimin Zhou, *Technology Upgrading and China's Growth Strategy to 2020*, The Ctr for Int'l Governance Innovation Working Paper No. 21, (2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982232.

134. Margalioth, *supra* note 56, suggests in his paper that developing countries may gain a comparative advantage over developed countries if they drop their corporate tax rates (even to zero) and rely on other forms of taxation (as they anyway do).

tax competitiveness. Finally, the harmful tax competition movement and characterization of China as a “production haven” may have persuaded some policy makers to remove these havens.

The most important factor of all is China’s confidence in attracting FDI without FDI specific incentives. The Finance Minister explained:

International experience has shown that political stability, sound economic development, big market, rich human resources, constantly improving legal environment and government services are main factors for absorbing foreign investment, and the tax preference is only one factor. Therefore, the new Tax Law will not exert a great impact on foreign investment.

It is clear that China has not abandoned its policy of attracting FDI. In lieu of FDI-specific tax incentives, China hopes to better attract FDI by offering lower tax rates than other countries.¹³⁵ The Minister of Finance stated:¹³⁶

[T]he level of enterprise income tax rates in the world, especially the neighboring countries (regions), has to be taken into account. The average enterprise income tax rate is 28.6% in 159 countries (regions) around the world in which an enterprise income tax is applied, while that in China’s 18 neighboring countries (regions) is 26.7%. The rate of 25% set in the Draft is relatively low in the world and will be conducive to enhancing enterprise competitiveness and attracting foreign investment.

Preliminary impact on FDI – The new tax law has been perceived thus far to reflect “a growing confidence in China’s global standing, not only for

135. The SAT relied on research data indicating the prevailing corporate tax rate in 20 industrial countries (including EU members, Australia, Canada, New Zealand, Japan and the United States) and 22 non-industrial countries (including Brazil, Chile, Hungary, India, Malaysia, Mexico, the Philippines, Poland, Romania, Thailand, Turkey, Peru, Argentina, Mongolia, Vietnam and Iran). The research report is published at the SAT website: www.chinatax.gov.cn (in Chinese). Empirical research indicates that general corporate tax rate is a better instrument than selective tax incentives as a means to encourage FDI inflow: Thiess Buettner and Martin Ruf, Tax Incentives and the Location of FDI: Evidence from a Panel of German Multinationals, Deutsche Bundesbank Discussion Paper Series 1: Economic Studies, No.17/2005, available at <ftp://ftp.zew.de/pub/zew-docs/dp/dp0476.pdf>; W. Steven Clark, Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options, Can. Tax J. 1139 (2000).

136. Jin, *supra* note 113.

lower cost manufacturing, but as a consumer market with its own draw.”¹³⁷ This, in itself, has a positive impact on investors’ confidence in China. The new tax law certainly provides more certainty and predictability for investors by removing many aspects of administrative discretions in approving tax incentives, fixing the tax rate, and less state interference in investment and business decisions. It is expected that the original tax incentive policy started the engine of China’s economic development and that the new tax policy will support and sustain the development.

The new EIT Law also continues with the basic framework of the existing FIE Tax Law, which incorporated many concepts and principles of corporate taxation used in OECD countries. The tax incentives are designed to promote long-term, sustainable investment and development.¹³⁸ Tax preferences continue for favoured activities. Instead of tax holidays, the new law provides incentives in the form of accelerated deductions for research and development expenses and certain capital expenditures. Instead of FDI specific tax rate reductions, the new law provides for a lower rate of 20% for all “small” enterprises and 15% for all “high-tech” enterprises.¹³⁹ It is expected that more than half of existing FIEs qualify as either small enterprises or high-tech enterprises.

Investors and capital markets in China appear to welcome the new tax law as they expect the big domestic companies – the major banks, telecom companies, oil and gas producers – that dominate indexes of Chinese stocks – will see their after-tax earnings boosted by the tax change.¹⁴⁰ Foreign investors looking for a more transparent and neutral tax policy as part of investment environment welcome the changes. For example, US technology firm Motorola declared that it had no plans to alter its investment strategy in China. US-based General Electric said it will respond to the incentives for clean technologies by investing 50 million U.S. dollars to build a Shanghai technology center for

137. Tom Leander, *How Big a Bite? The big changes in China’s tax code reflect a shift in economic priorities. But much about the law remains a mystery*, CFO Asia (May 2007), available at <http://www.cfoasia.com/archives/200705-10.htm>. The 2007 tax reform has been perceived to represent China’s commitment to the WTO, which can only strengthen China’s attraction to foreign investment. The tax increase for FIEs “will not crush out the zest of foreign investment” because “what weighs in their decision is China’s huge market potential.” Thus far, negative reaction to the new law is mostly associated with the lack of detailed rules and regulations to implement the law.

138. Tax-preferred investments include those in agriculture, forestry, animal husbandry and fishery, public infrastructure, environmental protection, energy and water resources conservation, research and development and transfers of technology.

139. EIT Law, *supra* note 40, art.4 & 28.

140. Andrew Baston, *China’s Expected New Tax Law would Even the Playing Field*, *The Wall Street J.* Feb. 26, 2007, at C9.

environmentally friendly products.¹⁴¹ Similarly, established FIEs that have used up their tax holidays or are engaged in the activities that are tax-favoured under the new law (such as research and development, infrastructure, environmental industries, etc.) stand to benefit under the new law.¹⁴²

Foreign manufacturers that are making products for sale in China are attracted to China by the internal market, not the tax incentives. As such, ending the FDI-specific tax incentives had minimal impact on these investors. Foreign investors contemplating activities in non-productive activities (such as services) would be similarly unaffected by the new tax policy as such activities were not eligible for tax incentives under the previous regime.¹⁴³ “Footloose” investors may move out of China to jurisdictions offering lower corporate tax rates, such as Vietnam, but the sign of such flight is not yet emerging.

C. Harmful Tax Competition

According to the OECD report on Harmful Tax Competition Report: An Emerging Global Issue¹⁴⁴ countries engage in harmful tax competition by offering “preferential tax regimes” or being tax havens. Tax havens are harmful to other countries by eroding their tax base, thereby reducing those countries’ revenue for financing social welfare.¹⁴⁵ Preferential tax regimes also erode the tax base of other countries.¹⁴⁶ In addition, by distorting locational decisions, FDI may be located in a country where the pre-tax return is lower, thereby reducing the global efficiency in allocation of resources. The OECD’s position has been well debated in literature¹⁴⁷ and the views are mixed.¹⁴⁸

141. Leander, *supra* note 137.

142. *Id.* Leander, reports that some multinationals have adapted their business plans to the policy change. GE (General Electric) China has announced it will invest 50 million U.S. dollars in its Shanghai-based technology center for products serving environmental protection, including more efficient airplane engines and wind power generators, seawater desalination technology and energy-saving bulbs.

143. See Olivia Chung, Mixed feelings over China’s new tax system, *China Business*, Mar. 21, 1997, available at http://www.atimes.com/atimes/China_Business/IC21Cb01.html.

144. OECD 1998 Report, *supra* note 115; OECD, *Towards Global Tax Co-Operation: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices*. Paris, OECD 2000.

145. OECD 1998 Report, *supra* note 115.

146. *Id.*, ¶ 4.

147. See, for example, Reuven Avi-Yohan, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 *Harv. L. Rev.* 1573 (2000); – Reuven Avi-Yohan, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 *Mich. J. Int’l L.* 371 (2004); William B. Barker, *Optimal International Taxation and Tax Competition: Overcoming the Contradictions*, 22

China is clearly not a classic tax haven.¹⁴⁹ Chinese FDI tax incentives are technically not “preferential tax regimes” because they are designed “to attract investment in plant, building and equipment” not “geographically mobile activities.”¹⁵⁰ And yet, these incentives were intended to attract investment away from other countries to China’s “production havens.”¹⁵¹ Classic tax havens have been leading sources of FDI inflow to China. The British Virgin Islands, Cayman Islands, Samoan and Mauritius are among the top ten sources.¹⁵² In 2005, for example, FDI from British Virgin Islands (USD5.96 billion) was more than five times of that from the United States (USD1.03 billion).¹⁵³ Therefore, China offers an interesting case study on the issue of harmful tax competition as well as the interaction between the tax laws of the home country and the host country. Two specific questions are examined below: (a) Are the Chinese tax incentives responsible for changing the investor’s decision to invest in China rather than at home; (b) Are these incentives responsible for increasing the use of tax havens to avoid residence country’s tax?

Base erosion in the home country – Some recent studies show that source country tax incentives do not affect the decision of a multinational as to

NW. J. Int’l L. & Bus. 161 (2002); Karen B. Brown, Harmful Tax Competition: The OECD View, 32 Geo. Wash. J. Int’l L. & Econ. 311 (1999); Rajiv Biswas, ed. International Tax Competition: Globalization and Fiscal Sovereignty. London: Commonwealth Secretariat, 2002; Lorraine Eden & Robert T. Kudrle, Tax Havens: Renegade States in the International Tax Regime? 27 Law & Pol’y 109 (2005); Richard A. Johnson, Why Harmful Tax Practices Will Continue After Developing Nations Pay: A Critique of the OECD’s Initiatives Against Harmful Tax Competition, 26 B.C. Third World L. J. 351 (2006) (reviewing William Brittain-Catlin, Offshore: the Dark Side of the Global Economy (Farra, Straus, and Giroux 2005); Keith Engel, Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F, 79 Tex. L. Rev. 1525 (2001); Littlewood, *supra* note 63; Roin, *supra* note 114.

148. For example, Littlewood states that “The OECD seems on solid ground, therefore, in its assertion that tax havens generally detract from global welfare. There are, therefore, good reasons for eradicating tax havens” Littlewood, *supra* note 63, at 439. However, he finds the OECD position on preferential tax regimes problematic. Roin, *supra* note 114, argues against the OECD position in general. The essays included in the book edited by Biswas, *supra* note 147, generally support tax competition and take a negative view of trying to curb it. See Terrence R. Chorvat, A Different Perspective on Tax Competition, 35 Geo. Wash. Int’l L. Rev. 501 (2002).

149. China was referred to as a “production haven” because of the tax incentives were granted mostly to FDI engaged in productive activities. Avi-Yonah, *supra* note 114.

150. OECD 1998 Report, *supra* note 115, ¶ 6.

151. See Avi-Yonah, *supra* note 114.

152. For a list of origins of FDI, see China Statistical Year Book (2005), available at <http://www.stats.gov.cn/tjsj/ndsj/2005/html/R1815e.htm>.

153. *Id.*

whether to invest domestically or overseas in the form of FDI.¹⁵⁴ Once a multinational has decided to invest in a developing country, it is questionable whether the host country tax incentives actually affect the location of the investment. One view is that “once other factors have provoked the decisions to set up production facilities in a broad area, then the more precise location decision may be strongly affected by such [incentive] factors.”¹⁵⁵ Another view is that developing countries are in a “no-win” situation with respect to attracting FDI by using tax incentives as they seem likely to lose revenue without attracting additional FDI.¹⁵⁶

There is no conclusive evidence that Chinese FDI tax incentives enticed investment away from the investor’s home country, although it is possible that these incentives attracted FDI away from other developing countries, especially those in the same region. In terms of low-cost manufacturing and processing – investments in extractive industries, and other productive activities that are cost – sensitive, it is difficult to imagine that any OECD member country could compete with China for similar investment projects. Even if Chinese tax incentives were effective in influencing the location of FDI in China, they could not be said to have contributed to “poaching” the tax base of the investor’s home country.

Home country’s tax policy – In order to examine the potential harmful effect of Chinese tax incentives to the investor’s residence country, it is necessary to examine that country’s system of taxing foreign source income, especially foreign business income. At the moment, the residence country is typically a member of the OECD¹⁵⁷ that has either an “exemption” system, a “credit” system or a hybrid. Under the exemption system, foreign income earned by a resident is exempted from taxation in the residence country. Such exemption system is often justified on ground of capital import neutrality (CIN) in that the worldwide tax burden on the income is determined by the source country. Under a credit system, foreign income is taxable in the residence country, but a credit is granted for foreign taxes paid dollar for dollar up to the amount of domestic tax payable. The credit system is often justified on ground

154. See Devereaux & Freeman, *supra* note 56.

155. Morisset and Pirmia, *supra* note 57, reviewing a study by Forsyth in 1972: D. Forsyth, *US Investment in Scotland*. (Praeger 1972).

156. Goodspeed, *supra* note 80, at 13.

157. The overwhelming majority of multinational enterprises are resident in OECD countries. See Avi-Yonah, *supra* note 114, at 383. In 2004, only five of the top 100 multinational companies were from developing countries (China, Hong Kong, Malaysia, Korea, and Singapore), while 85 were from the EU, Japan and the United States; see United Nations, *World Investment Report 2006*, New York and Geneva 2006, http://www.unctad.org/en/docs/wir2006_en.pdf.

of capital export neutrality (CEN) in that foreign income is taxed in the same way as domestic income.¹⁵⁸

Generally speaking, Chinese FDI tax incentives cannot erode an exempt country's tax base¹⁵⁹ because Chinese income is not included in the tax base in the first place. In the case of a credit country, Chinese tax incentives have the effect of "giving" China's tax base to the residence country. Even if a tax sparing credit is granted by the residence country, its tax base cannot be said to have been eroded by Chinese tax incentives, because the tax base is the same as if Chinese taxes were paid.

Because Chinese tax incentives apply mostly to FDI and portfolio investment in China remains limited,¹⁶⁰ the focus of the debate is the possible erosion of the tax base related to foreign business income. We will use Canada and the United States as examples in demonstrating whether Chinese tax incentives actually erode the tax base of these countries.

158. It is beyond the scope of this article to overview the literature on international tax neutralities and the classification of tax systems of OECD countries. For further reference, see Hugh J. Ault & Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis* (Kluwer Law International 2d ed. 2004); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 *Tex. L. Rev.* 1301 (1996); Michael Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 *Tax L. Rev.* 261 (2001); Michael Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 *Tax L. Rev.* 537 (2003); Shaviro, *supra* note 124.

159. The exemption system generally does not apply to foreign portfolio income as a result of anti-deferral rules under domestic tax law. For an overview of these rules, see Brian Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*. (Canadian Tax Foundation 1986); Daniel Sandler, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundries* (Deventer, The Netherlands 2d e. 1998); IFA, *Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends*, 86b *Cahiers de droit fiscal international* (2001); OECD, *Controlled Foreign Company Legislation*, Paris, OECD, 1996; United States Department of Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* (Dec. 2000).

160. Earning portfolio income in China through a Chinese resident corporation is not yet common. Chinese regulations generally require FIEs to be engaged in production and business activities. Investment holding companies are allowed only to hold investments in the same corporate group. In 2005, while FDI inflow was valued over 603 billion U.S. dollars, Chinese companies issued USD1.6 billion worth of shares overseas and entered into 1.08 billion U.S. dollars of international leasing transactions. Technology transfers are generally associated with FDI; FIEs imported more than half of the foreign technology imported by China. See Ministry of Commerce, <http://zhhs.mofcom.gov.cn/aarticle/Nocategory/200707/20070704841184.html>, visited on Jul. 12, 2007.

Canada – Canada is generally a credit country,¹⁶¹ but implements an exemption system with respect to foreign active business income. In determining the amount of foreign tax credit, Canada has traditionally allowed a tax sparing credit (including one under the Canada-China Tax Treaty). Foreign portfolio income is currently taxable whether or not it is earned through a foreign corporation, whereas foreign business income earned through a foreign affiliate is not currently taxable. Foreign active business income earned through a foreign affiliate resident in a treaty country¹⁶² is included in an “exempt surplus” account of the foreign affiliate. Dividends paid of the exempt surplus account are “exempt dividends,” fully excluded from the Canadian parent’s income.¹⁶³ In effect, foreign active business income is subject to tax only in the foreign country. Canadian tax is payable only when the Canadian company distributes dividends to individual shareholders in Canada or to non-resident shareholders.¹⁶⁴

Assuming that a Canadian resident company, Canco, carries on business in China through a branch or permanent establishment and the Chinese income is free from Chinese tax under the tax incentive legislation. For Canadian tax purposes, Canco must include its Chinese income in reporting its worldwide income and claim a credit for Chinese tax. Under the standard foreign tax credit rules, since no Chinese tax was paid, there is no credit available. However, by virtue of the tax sparing credit, Canco can obtain a credit for the Chinese tax that would have been paid in the absence of the tax incentives. To the extent that the Canadian tax rate exceeds the nominal Chinese rate, Canco still has Canadian tax payable. In other cases, there is no Canadian tax payable, so that the Chinese income is free from tax in both China and Canada. In this case, it is the tax sparing credit granted by Canada that reduces the Canadian tax base, not Chinese tax incentives.

161. The Canadian FAPI regime technically adopts a “gross-up” and deduction system that mimics a foreign credit system. For further discussion, see Li, Cockfield and Wilkie, *Canadian International Taxation: Principles and Practices*, (Lexis-Nexis, 2006.)

162. If the foreign business income is earned by a foreign affiliate in a non-treaty country, it goes to a “taxable surplus” account and the dividends paid of such account are taxable. An “indirect foreign tax credit” is available to recognize the foreign corporate income tax paid with respect to the taxable dividends received by a Canadian corporate shareholder. *Income Tax Act*, R.S.C. 1985, c.1 (5th supp.), as amended, [hereinafter *ITA*], § 113(1)(b).

163. *ITA*, § 113(1)(a).

164. If the individual shareholder is a resident, a dividend tax credit is available. If the shareholder is a non-resident, a withholding tax of 25% (reduced by treaties) applies to the amount of dividends received. If the shareholder is a corporation or tax exempt entity (such as a pension fund), the dividends are not taxable.

What if Canco carries on business in China through a wholly-owned subsidiary (a “foreign investment enterprise” under Chinese law)?¹⁶⁵ Any business income earned by the Chinese subsidiary is not currently taxable in Canada. Because China is a “designated treaty country,” the dividends received by Canco qualify as “exempt dividends,” not taxable in Canada. China imposes no withholding tax on the dividend payments.¹⁶⁶ As such, the Chinese income can be repatriated to Canada without either Chinese or Canadian tax. When Canco distributes the dividends received from China to its shareholders, the shareholders (whether resident individuals or non-resident) are liable to pay Canadian tax.¹⁶⁷ The Canadian tax base could be considered as being eroded to the extent of non-taxation of the Chinese business income when earned and when repatriated to Canco. However, such erosion is really caused directly by Canadian tax policy, not Chinese tax incentives. Canada chose to implement CIN by exempting Chinese business income from Canadian tax.

What if Canco makes its investment in China through a wholly-owned subsidiary in a tax haven? A popular tax haven for Canadian companies is Barbados. Assuming Canco establishes a foreign affiliate in Barbados (BFA) that qualifies as an International Business Corporation and taxable at the rate of 3%. BFA then invests in a Chinese FIE. The FIE qualifies for a tax holiday under Chinese tax incentives legislation and pays no Chinese income tax. After the expiration of the tax holiday, the FIE borrows money from BFA to expand operations. The interest expense is tax deductible in China.¹⁶⁸ The interest received by BFA, although formally passive income from property subject to the anti-deferral rules¹⁶⁹ (similar to the US SubPart F rules), is deemed to be

165. For Canadian income tax purposes, a Chinese FIE, other than a contractual joint venture that takes the form of a partnership or contractual arrangement, is generally characterized as a corporation. If a Canadian corporation owns 10% or more of the equity interest in an FIE, the FIE is a foreign affiliate.

166. As long as the business income stays in a “corporate solution,” no Canadian tax is payable. The Canadian corporation excludes the dividends from the Chinese FIE under § 113(1)(a) of the ITA. If it pays dividends to another Canadian resident corporation, the inter-corporate dividends are tax-free under the ITA (§ 121).

167. Canadian personal income tax is applicable to any capital gains realized by a resident shareholder. As such – to the extent that the gain is derived from the value of the Chinese business income, which is increased by the tax incentives – Canada can tax it.

168. Interest paid to the BFA may be subject to a Chinese withholding tax at the rate of 10%. See China-Barbados Tax Treaty, Article 10, available at SAT website.

169. ITA §§ 91 & 95. Under the Canadian foreign accrual property income (FAPI) rules, a Canadian resident shareholder is currently taxable on the FAPI earned by a controlled foreign affiliate. The most important type of FAPI is foreign portfolio income. Dividends, interest, rents and royalties received by a tax haven affiliate from a related affiliate (i.e., a Chinese FIE) are generally deemed to be active business income, and thus excluded from FAPI.

active business income.¹⁷⁰ Because Barbados is a “designated treaty country,” the interest income is added to its exempt surplus, out of which exempt dividends can be paid to Canco. This tax structure is attractive to Canco because Canco can finance its operations in China by borrowing funds to subscribe shares of BFA and obtain a “double dip” for the interest expense: once in China by the FIE, and again in Canada by Canco.¹⁷¹ This type of international double-dip was considered offensive to tax policy because the dividends are exempt from Canadian tax. But a recent proposal¹⁷² to end the double dip generated a storm of protest from business and tax professionals and had to be significantly narrowed down. This illustrates the fundamental point that the erosion of Canadian tax base is the direct result of Canadian tax policy,¹⁷³ not Chinese tax policy.

United States – The United States is also a credit country, but implements CEN largely in the case of foreign portfolio income. The United States has never granted a tax sparing credit to any developing country, including China.¹⁷⁴ Foreign business income is taxable in the United States if earned directly by a United States corporation. Because of the check-the-box

170. ITA § 95(2)(a) of the Income Tax Act.

171. In addition to using the Barbados affiliate as a financing vehicle, it can be used to hold valuable intangibles or channelling management fees. Royalties and management fees paid by the Chinese joint venture are deductible in China. Chinese withholding tax is zero on management fees and maximum of 10% on royalties by virtue of the China-Barbados Tax Treaty. The Chinese source management fees and royalties are added to the Barbados affiliate’s “exempt surplus” out of which exempt dividends are paid. If Barbados were not a treaty country, the interest, royalty and management fees would go to a “taxable surplus” and only “taxable dividends” can be paid to the Canadian parent. So, in the case of Canadian companies, using a tax haven that has a treaty with China and Canada is extremely beneficial.

172. See, Background, *International Tax Avoidance and Tax Havens*, published by the Department of Finance, Canada, http://www.fin.gc.ca/news07/data/07-041_2e.html.

173. Canada has not attempted to amend the FAPI rules because of the policy concern for CIN and the competitiveness of Canadian multinationals. Territorial taxation of active business income is a fundamental principle in Canadian international tax law. Excluding interest, royalties and rents from FAPI is consistent with this principle as long as these payments are received from a related foreign affiliate that deducts the payments in computing its active business income. In other words, the origin of these payments is an active business and the business income should be taxed in the country where the business is carried on.

174. See Karen B. Brown, *Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?* 23 U. Pa. J. Int’l Econ. L. 45, at 78 (2002); Paul D. Reese, *Comment, United States Tax Treaty Policy Toward Developing Countries: The China Example*, 35 UCLA L. Rev. 369 at 379 (1987). For further comments, see Laurey Damian, *Note: Reexamining U.S. Tax Sparing Policy with Developing Countries: The Merits of Falling in Line with International Norms*, 20 Va. Tax Rev. 467 (2000).

rules,¹⁷⁵ Chinese joint ventures may be checked as flow-through entities.¹⁷⁶ Foreign business income earned indirectly through a foreign affiliate is not currently taxable in the United States. Dividends received from such affiliates are taxable in the United States after a deduction for a direct and indirect foreign tax credit. There are proposals¹⁷⁷ to replace the credit system with a territorial or exemption system, but they have not been adopted into law.

Assuming a United States corporation, USCo, carries on business activities in China through a branch or permanent establishment and the Chinese income is exempted from Chinese tax. Under United States law, the Chinese income is currently taxable. USCo cannot claim any credit for the Chinese tax because there is no tax sparing credit available. USCo ends up paying United States tax on its Chinese income.

If USCo carries on business in China through a Chinese FIE and treats the FIE as a corporation, the FIE's business income is not currently taxable in the United States. When the FIE pays dividends to USCo, the dividends are free from Chinese withholding tax, but are taxable in the United States. Since there is no Chinese taxes paid and there is no tax sparing credit available, there is no direct or indirect foreign tax credit for Chinese taxes. The United States ends up taxing the Chinese income in full. As such, Chinese tax incentives clearly do not cause any base erosion in the United States. There are the benefits of deferral and averaging, but, as argued in the context of Canada, this is the result of US tax policy. The United States could disallow such benefits, but choose not to.

If USCo invests in China through a tax haven subsidiary, the main tax advantage is the deferral of U.S. tax on the dividends and other payments received from the Chinese FIE. As long as the income is outside the Subpart F regime, there is no immediate taxation of the tax haven subsidiary's income. If the dividends, interest, royalties, and management fees were received from China directly by USCo, they would be currently taxable in the United States.

175. Regs. § 301.7701-2.

176. Pierre Maugue, *Tax Incentives in the People's Republic of China: Who Benefits?* 5 *Tul. J. Int'l & Comp. L.* 155 (1997).

177. President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (2005); and Staff of J. Comm. On Taxation, 108 th Cong., *Options to Improve Tax Compliance and Reform Tax Expenditures* (2005). Earlier in 2005, the staff of the Joint Committee on Taxation suggested a similar shift on the basis of two arguments. First, the credit system allows deferral of US taxation of foreign earnings of US-owned foreign corporations, which distorts business decisions on where and how to invest these earnings (presumably the earnings are not repatriated to the US for tax reasons). Second, the credit system often allows US multinational corporations to achieve US tax results more favorable than they could obtain under an exemption system. For more comment, see Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, Vol.59 *S.M.U. L. Rev.* 751-72 (2006).

It is thus not surprising that Luxembourg, Bermuda, Barbados, UK Caribbean Islands, and The Netherlands are among the countries with the largest US affiliate operations.¹⁷⁸ Avoiding U.S. tax by American companies in such manner can hardly be blamed on Chinese tax incentives. The removal of Chinese tax incentives after 2007 will unlikely change the investment pattern of American companies.

To sum up, tax incentives in China result in non-taxation of income earned in China. They do not have the effect of eroding the tax base of the residence country. For an exemption country, this point is very clear. If the residence country has a credit system, including a tax sparing credit, such as Canada, the conclusion is the same – Chinese tax incentives do not erode that country's tax base against its wish. If the residence country has a credit system without a tax sparing credit, such as the United States, the non-taxation in China is, in effect, a "gift of tax base" from China as it can tax Chinese income in full. This analysis is the same whether FDI in China is made directly from the residence country or indirectly through a tax haven jurisdiction. Ultimately, the tax base of the residence country is eroded to the extent of tax deferral achieved, but it is the result of the domestic tax policy of the residence country.

D. Inter-nation Equity and Redistribution

The issue of inter-nation equity and redistribution has received increasing attention in tax literature. Scholars have suggested that developed countries assist developing countries through tax sparing credits,¹⁷⁹ broader source-based tax jurisdiction through tax treaties,¹⁸⁰ or amended domestic Subpart F rules.¹⁸¹ However, the inter-nation equity implications of the FDI tax incentives offered by developing countries have not been addressed much in literature. While formal redistribution from a high-income country to low-income countries through the above mentioned measures remains theoretical,

178. See U.S. MNE Operations, 2003, reproduced in Kimberly A. Clausing and Reuven Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* (The Brookings Institution, Jun. 2007).

179. See Brown (2002), *supra* note 174. For a reply to Brown's argument see McDaniel, *supra* note 57. See also Karen Brown, *Transforming the Unilateralist into the Internationalist: New Tax Treaty Policy Toward Developing Countries*, in *Taxing America*, (Karen B. Brown & Mary Louise Fellows, eds. 1996, at 214.).

180. Kim Brooks, *Tax Treaty Treatment of Royalty Payments from Low-Income Countries: A Comparison of Canada and Australia's Policies*, 5(1) *eJournal of Tax Research* (2007) (forthcoming) (suggesting a broadening of the source taxation over royalties as a means of helping developing countries); Allison Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71 *Brooklyn L. Rev.* 639 (2005) (US tax treaties have functioned ineffectively as a means for assisting low-income countries).

181. McDaniel, *supra* note 57.

the implicit redistribution of tax base from a low-income country to high-income countries occurs whenever the former grants tax incentives to investors from the latter. A normative analysis of the effect of Chinese FDI tax incentives seems to indicate this.

Inter-nation equity – Inter-nation equity requires a fair allocation of the international tax base among countries.¹⁸² It is extremely difficult, if at all possible, to determine whether a country's share of the international tax base is "fair" or "equitable." The allocation may be considered to be equitable "if every country has the right to tax all profits having their source within its borders."¹⁸³ In the case of bilateral tax treaties, those that are based on the UN Model Tax Convention are generally considered more equitable to developing countries as they allow more source-based tax jurisdiction than the OECD Model Tax Convention.¹⁸⁴

The standard debate on inter-nation equity has little bearing on the analysis of FDI tax incentives granted by low-income countries as these countries "voluntarily" give up their tax base in the hope of enticing FDI. Nonetheless, the existence of these FDI specific incentives certainly worsens the inequity in the sharing of the tax base between the low-income host country and the high-income home country.

Inter-nation redistribution – In a single-state context, equity generally requires redistribution of income by way of progressive taxation.¹⁸⁵ In an inter-nation context, there is no similar mechanism for redistribution at the level of taxpayers. Globalization may have increased the need for inter-nation redistribution.¹⁸⁶ Indeed, "there appears to be no sound theoretical reason to

182. See Peggy Musgrave, *Tax Policy in the Global Economy*, in *Studies in Fiscal Federalism and State-Local Finance*, UK 2002. For a review of this concept, see Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* chapter 13. (Canadian Tax Foundation 2003).

183. A. Schafer and C. Spengel, *The Impact of ICT on Profit Allocation within Multinational Groups: Arm's Length Pricing or Formula Apportionment?* Centre for European Economic Research, at <ftp://ftp.zew.de/pub/zew-docs/dp/dp0353.pdf>.

184. Alex Easson, *International Tax Reform and the Inter-Nation Allocation of Tax Revenue*. Wellington, New Zealand: Victoria University Press, 1991, at 20.

185. For more analysis of inter-individual equity, see Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42, *National Tax J.* 139 (1989); Paul R. McDaniel and James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1, *Fla. Tax Rev.* 607 (1993); Martin J. McMahon, Jr. and Alic G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 *Fla. Tax Rev.* 1 (1998).

186. See, e.g., Michael A. Livingston, Blum and Kalven at 50: *Progressive Taxation, 'Globalization,' and the New Millennium*, 4, *Fla. Tax Rev.* 731 (2000). For a discussion of fairness in international taxation, see J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 *Fla. Tax Rev.* 301 (2001).

restrict redistribution to members of any single tax jurisdiction.”¹⁸⁷ However, inter-nation redistribution of income has not been widely espoused, even among proponents of inter-nation equity.¹⁸⁸ No nation has ever made a genuine commitment to worldwide equity.¹⁸⁹ In the absence of a world government, the fact remains that “the freedom and independence, as well as the economic welfare, of people varies from nation to nation.”¹⁹⁰ It is not even considered desirable by some scholars to have a world government because it “would likely become a dictatorship.”¹⁹¹

Under the current international tax regime, the tax sparing mechanism can be viewed as an instrument of redistribution as the home country foregoes the right to tax its residents on their foreign income. This mechanism has been recently scaled back by OECD countries on ground of abuse and potential for international non-taxation.¹⁹² In theory, an inter-nation redistribution system could be envisioned through the design of tax rates:¹⁹³

For instance, the tax share in profits earned by non-residents might be allowed to rise inversely to the level of per capita income in [source jurisdiction] and directly in relation to per capita income in [residence jurisdiction]. Such a scheme would

187. See, for example, Reuven Avi-Yonah, *Globalization, Tax Competition, and The Fiscal Crisis of the Welfare State*, 113, 7 *Harvard L. Rev.* 1573-676, at 1649 (2000). A similar sentiment was expressed by Easson, *supra* note 185.

188. For example, Nancy Kaufman argues that inter-nation equity should be the foundation of an equitable international tax system, but did not expand the concept to include inter-country redistribution; see *Equity Considerations in International Taxation*, 26, *Brooklyn J. Int'l L.* 1465 (2001). See also Kaufman, *Fairness and the Taxation of International Income*, 29, *Law & Policy in Int'l Business* 145-203 (1998).

189. Graetz, *supra* note 159, at 278.

190. *Id.*, at 278.

191. *Id.*, at 278. In this respect, Graetz cites John Rawls, *The Law of Peoples* (1999) and F. H. Hinsley, *Power and the Pursuit of Peace* (1996).

192. *OECD Tax Sparing: A Reconsideration*. (1998).

193. Peggy B Musgrave and Richard A. Musgrave, *Fiscal Coordination and Competition in an International Setting*, in L. Eden, ed., *Retrospectives on Public Finance*. Durham, NC: Duke University Press (1991), 61-85, at 65-6; *Inter-Nation Equity*, in Richard M. Bird and John G. Head, eds., *Modern Fiscal Issues*. Toronto: University of Toronto Press, 1972, 63-85; Peggy B. Musgrave, *Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union*, in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* 47-77; (Oxford University Press 2000); Peggy B. Musgrave, *Revisiting the Theory of International Income Taxation: Principal Paper: Sovereignty, Entitlement, and Cooperation in International Taxation*, 26, *Brooklyn J. Int'l L.* 1335 (2001).

be of particular interest in the relation between developed and developing countries.¹⁹⁴

Reverse redistribution – While the current international tax regime has no formal system of inter-nation redistribution, there is a de facto reverse redistribution as a result of the FDI tax incentives granted by low-income countries. The extent of such reverse redistribution depends on who bears the burden of corporate income tax. “Unfortunately, after decades of analysis, no consensus exists on the incidence of the corporate tax.”¹⁹⁵ In theory, three possible groups of individuals may ultimately bear the burden of corporate tax and thus reap the fruits of tax incentives: shareholders, workers, and customers.

In the case of Chinese tax incentives available to FDI, two of the three groups of individuals are predominantly non-residents of China. Workers of FIEs are generally Chinese. They may benefit from tax incentives if part of the tax savings is shifted to them in the form of higher wages. There has been little evidence suggesting that FIEs have actually passed their tax savings to Chinese workers. Low wages has been one of the factors attracting FDI to China in the first place. Individual shareholders of companies investing in China are presumably resident in high-income OECD countries.¹⁹⁶ FIEs that benefit from Chinese tax incentives export their products to mostly high-income countries, such as the United States, Japan, Germany, UK, and Canada.¹⁹⁷ In terms of per capita GPI (gross national income), the United States ranked 10th (44,970 U.S. dollars), Canada ranked 23rd (36,170 U.S. dollars), and China ranked 129 in the world in 2006 (2,010 U.S. dollars).¹⁹⁸

To the extent that shareholders and customers of a multinational corporation that ultimately benefit from the Chinese tax incentives and residents in high-income countries, the tax base given up by China has been shifted to these individuals and their government. Given that China is a low-income country, such shift of tax revenue is an upside down subsidy to a high-income

194. Musgrave, *id.*, at 59.

195. Avi-Yonah (2004), *supra* note 114, at 381. For a similar conclusion, see Roin, *supra* note 114, at 575-8.

196. Top exporters of FDI to China include Japan, the United States, Germany, the Netherlands, Korea, and Singapore. Ministry of Commerce of the People's Republic of China, <http://www.mofcom.gov.cn/article/tongjiziliao/v/200706/20070604787959.html>, visited on Jul. 2, 2007.

197. China's top export destinations are: the United States (about 1/5 of all Chinese exports), Japan, Germany, The Netherlands, UK, France, Italy, Spain, Canada, South Korea, and Australia. See International Monetary Fund; General Administration of Customs (Beijing); Time, Jul. 9, 2007 at 26-7.

198. See World Development Indicators database, World Bank, 1 Jul. 2007: www.siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf.

country.¹⁹⁹ This is perhaps the “price” China was willing to pay in order to attract FDI to China,²⁰⁰ but the fact remains that the redistribution puts the ability-to-pay principle on its head.

Furthermore, it could be argued that the benefit of Chinese tax incentives is shifted to the government of capital-exporting countries. As discussed in the context of Canada and the United States, shareholders of companies investing in China are ultimately taxable in the residence country on dividends or capital gains from the sale of shares.²⁰¹ To the extent that dividends or capital gains include the tax savings shifted from China, the residence country actually taxes the amount of tax foregone by China, resulting in an indirect shift of revenue from the China’s fisc to that of the residence country.²⁰² Similar reverse redistribution is likely the outcome of FDI tax incentives granted by other developing Countries.

V. CONCLUSIONS

On the basis of the Chinese experience with FDI tax incentives, several conclusions can be made. First, FDI-specific tax incentives can be effective under the “right” conditions. When the conditions change and foreign investment would have been made in any event, tax incentives became not only redundant, but also impediments to economic development. Second, the efficiency of FDI-specific incentives is dependent on their effectiveness in attracting investment that can generate positive externalities. So, effective incentive measures are also efficient. However, when incentive measures encourage “round tripping” or other investment behaviours that have no positive externalities, they became inefficient. Third, equity implications of FDI tax incentives have not received much consideration. Like many types of tax expenditures, FDI tax incentives tend to have the effect of reverse redistribution.

199. If the lost tax revenue must be made up by the Chinese government through reduced spending that would otherwise benefit Chinese citizens, each Chinese citizen theoretically gives up some revenue in favour of a richer person in a foreign country.

200. Because the redistribution aspect of Chinese FDI incentives has not been discussed in China, there is no official statement that such reverse redistribution was intended by the Chinese government. It is safe to assume, though, that such intention did not exist in 1979 when the first tax incentives for FDI were introduced.

201. In the case of public companies, shareholders may be taxed when they sell the shares and realize capital gains. Consequently, business income earned in China that is eligible for Chinese tax incentives indirectly becomes part of the tax base of the residence country when dividends are repatriated from China to the company and from the company to its shareholders.

202. This could not have been intended as part of China’s foreign policy or development policy. For a capital exporting country, Graetz suggests that it is possible to consider redistribution internationally as a function of international tax policy (*supra* note 158, at 309).

This is arguably true at the international level: China and Chinese taxpayers give up tax revenue for the benefit of the government and residents of capital-exporting countries. Finally, on the issue of international harmful tax competition, the paper shows that FDI-specific tax incentives in China hardly erode the tax base of capital-exporting countries. The decision of OECD countries not to tax foreign business income on a current basis in the residence country gives effect to Chinese tax incentives. When a residence country decides not to tax business income earned in China, it is difficult to say that its tax base is eroded by China's decision not to tax the income. If OECD countries collectively decide to currently tax foreign business income in order to protect their tax base,²⁰³ redistribution from developing countries to OECD countries would be more evident and severe. Developing countries should rethink about their FDI tax policy and perhaps emulate China in abolishing tax incentives.

203. See Avi-Yonah (2004), *supra* note 114 (suggesting a multilateral attack on tax competition to be led by the World Trade Organization).